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Securing the future : taking succession to the next level

William L. Reeb

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Bill Reeb, CPA/CITP, has been consulting for three decades for businesses of all sizes and became a CPA in 1986. Prior to his life as a consultant, he worked in sales for IBM. As an entrepreneur, he has founded eight small businesses in various industries.

Bill is an award-winning public speaker; he lectures throughout the U.S. and Canada and has been featured on numerous television programs. Also an award-winning author, he is internationally published, with numerous books and hundreds of articles and columns to his credit.

His honors include being named a CPA Ambassador and presented with the Pathfinder Award and serving as the Texas Vision Delegate. He also has been recognized as one of the Top 100 Most Influential CPAs, named one of the Top 100 Most Influential Practitioners, and listed as one of the Most Recommended CPA Firm Consultants.



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Foreword



The AICPA's Private Companies Practice Section (PCPS) is proud to be a part of the *Securing the Future* publication series. When succession planning was identified as a significant profession issue back in 2004, PCPS was there and hired one of the true thought leaders in the profession, Bill Reeb, CPA to gain further insight and to create a publication to address the needs of the profession in this area.

Fast forward four years to 2008, when PCPS again called on Bill to conduct research into this issue and—based on past experience and current issues raised—help PCPS create the PCPS Succession Resource Center. Bill and his partners, Dominic Cingoranelli and Michaelle Cameron, founders of the new organization the Succession Institute, collectively developed the materials and worked in getting the PCPS Succession Resource Center live and content rich on the PCPS Web site (www.pcps.org). The Succession Resource Center is web based learning, and houses both text and video content on succession issues. In addition to its online offerings, PCPS also wanted to provide a print version for the broader audience. We went back to the Succession Institute team to create a second publication in this *Securing the Future* series.

As part of the succession research, PCPS conducted a survey in 2004 and 2008. The results of the 2008 survey showed slight improvement with 35% of responding multi owner firms and 9% of sole proprietors reporting having a succession plan in place. In 2004, only 25% of multi owner firms and 8% of sole proprietors had a plan. While it appears that some progress has been made, a great deal of work remains to be done in our profession to prepare for succession within firms.

While many firms aren't focused directly on Succession Planning, PCPS has realized that succession issues are more about how you manage your practice than a standard profession rule of thumb on what the multiple may be to calculate value. In the first volume, *Securing the Future: Succession Planning Basics*, does a great job in setting up the reader to start down the proper path of succession by focusing on internal operations. This volume, *Securing the Future: Taking Succession to the Next Level*, builds on what is learned in this book and helps apply that learning to the succession strategy you determine for your firm. We believe that the two volumes in this set are "must reads" for anyone in public accounting who is contemplating succession planning or retirement.

However, even if succession or preparing for imminent retirement are not high priorities now, these two volumes are chock full of tools, techniques, ideas, and best practices that can help any professional firm operate more effectively, successfully, and profitability. We would like to thank Bill, Dom and Michaelle for their hard work and tireless contribution to the profession. The *Securing the Future* series is a true gem for the profession. We'd also like

to thank the PCPS Executive Committee who, since 2003, have kept a key focus on helping the profession with this very important issue. The leadership started with Rich Caturano and continued with David Morgan and we hope to continue to build on the pathway both have set for this committee in recent years.

William Pirolli, CPA

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Preface



Why This Book and Why Now?

We are on the precipice of an unprecedented transfer of ownership interests in accounting firms. For some CPA firm owners, transitioning their ownership will occur successfully with little pain, but for many, many others, there is a very high risk of severe disappointment coupled with financial shortfalls. The continuing demographic trends alone are an immense driving force that will exact a huge toll on those who have failed to adequately position their firms for succession by taking a big picture, holistic approach to making the practice and all its people better faster, and stronger.

Bill wrote *Securing the Future: Succession Planning Basics* in 2005 to address the need for succession planning throughout our profession in the face of the changing environment. Since then, we've continued to work with CPA firms throughout North America, and while we are finding that a few firms have made some progress in their succession planning, a great deal of work remains at the majority of the firms if their owners are to experience an orderly transition of the practice when it's time to exit, whether the transition is handled through an internal or an external transaction. The clock is ticking, and unfortunately for many, time is running out; implementing the types of holistic change required can take years, and it can be a difficult process.

We wrote *Securing the Future: Taking Succession to the Next Level* to help practitioners do just that—take their firm to the next level—in a timely fashion—before it's too late. *Taking Succession to the Next Level* builds on the concepts and approaches discussed in *Success Planning Basics*, which many CPAs have stated publically at conferences has become their “business bible” helping them through their transition.

Approach

In *Securing the Future: Succession Planning Basics*, Bill laid the foundation for CPAs who want to prepare their firms for succession management. In this book, Bill introduces the concept of “Superstar” versus “Operator” business models for firms, and walks readers through implications of these models for succession planning. Next, the text covers the following areas:

- The environment and strategy
- Structure and leadership needed for consistency
- Firm management and operations

- Growth and transition; increasing your firm's value
- Succession strategies

In *Securing the Future: Taking Succession to the Next Level*, we begin with a broad discussion of succession (chapter 1) followed by how our changing CPA profession is likely to impact the road you decide to travel in your succession planning pursuits (chapter 2).

Once you have walked through these two areas, we focus on what you should be considering to improve your overall practice, with the first step you need to take being that of positioning your firm for succession. Effective succession planning and implementation is really about operating your business in a manner that can continue beyond the founders of the company. It is about developing a high enough level of readiness at your firm so that when senior owners retire, they can do so without:

- Being missed,
- The firm undergoing chaos,
- Changing the values and culture of the firm, and
- Skipping a beat in effectively transitioning leadership.

A key to remember is that when a senior owner retires in most firms today, because the proper steps have not been taken, he or she often is creating three large voids for the remaining partners to fill. These voids are often more than the firm is ready to handle, and that is when bad things happen to good people. These voids are a loss of:

- Capacity (the partner's personal time managing client work/projects and charge hours),
- Capability (the unique technical skills that the firm grew to rely on to support its clients), and
- Client relationship management (the clients, friends of the firm, and referral sources the partner managed and maintained)

By the time a partner retires, all three of these issues should already have been addressed. Unfortunately what we find all too often is that often none of them are. We cover how to address these issues at your firm.

We also discuss several alternate routes for firm transition from which you may choose for your practice. The material is laid out to allow you to easily visit the points of interest that are most important to you. The routes are:

- Selling the firm in an external transfer
- Merging, either upstream or downstream
- Turning out the lights and walking away
- Developing the next group of leaders to carry on after you leave
- Selling the firm in an internal transfer, including covering the need for client transitioning and possible post-sale involvement at the firm
- Putting a price on your firm or ownership interest—dealing with the economics of what your interest or firm might be worth

With each of these areas, we will offer insight into information that should be beneficial to you, as well as steps you should take in order to better prepare you and your firm for your journey ahead.

In addition to the coverage of the material in each of these two books, we provide you with access to a variety of tools and videos that we created to support this material through the PCPS Succession Resource Center.

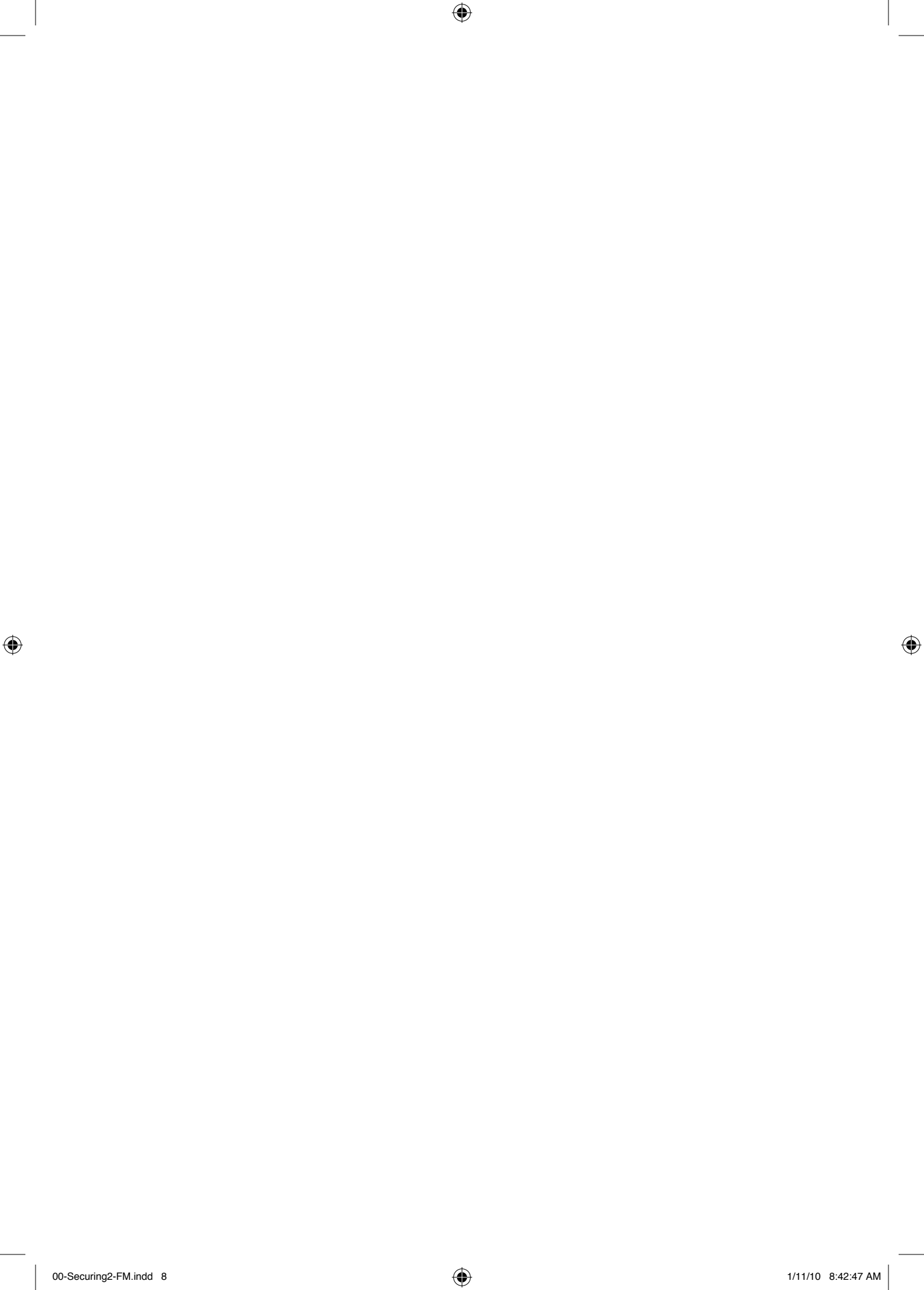
Succession Planning is About More Than Buy-Sells

When we discuss succession planning, most CPAs want to jump immediately to determining what their firm is worth. However, the value of your firm or ownership interest is dependent on many factors, most of which are directly within your control. Unless you take control of your succession planning destiny, all bets are off as to what the final value might look like.

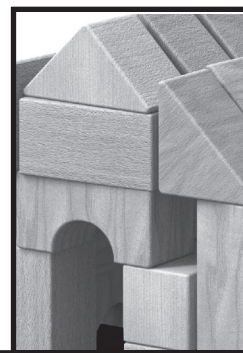
Similarly, many professionals think that succession management is predominantly about buy-sell agreements, buying tips, selling tips, insurance coverage, legal agreements, etc. Unfortunately, or fortunately, depending on your perspective, those issues are really just scenic overlooks or points of interest along your route. Succession management is really about the long stretches of road in between those destinations—like making a conscious effort to identify the future talent needs of the firm, from top to bottom. It's about people, processes and systems all being developed in the context of the firm vision or future direction.

The firm's future vision is vital: good succession management doesn't happen in a vacuum—it needs to be driven by your firm's long-term strategy. It involves taking a hard look at a firm's overall economics—from the way business is generated, work is allocated, people are rewarded, to your bottom line profitability. It requires leaders to think about how they can work themselves out of a job, rather than how can they make themselves indispensable. It requires everyone in the firm to constantly be developing their successor, regardless of the current position they hold, because no one can move up without someone being ready to fill their place. Succession management takes all of this, and more, into account. Properly done, succession management allows CPA firm owners to create options for their exit strategies. The more options you have, the less likely you will be compelled to commit to a route that you'd rather not travel. Or stated another way, the better the job you do at succession planning now, the greater your likelihood of a satisfactory outcome later.

We hope you enjoy your journey through this material as you prepare your firm and your people to become better, faster and stronger while simultaneously making the most out of your succession planning options!



Acknowledgments



First, we want to thank the PCPS Executive Committee for engaging us to do this project and the PCPS Succession Task Force, Mark Koziel and Jim Metzler for working with us throughout this process. Mark was both the project manager and the director for this project as his view as to what this material should address never wavered. He knew exactly how our succession information needed to be delivered in order to support the overall PCPS Practice Management Resource Center. As well, we want to thank Jim for his support of us in both this project and over the years as we always knew he wanted the best for us without compromising what was delivered to the membership. Bill Pirolli (Chair of the Succession Planning Task Force) and David Morgan (Chair of the PCPS Executive Committee) provided strong leadership in the level of information covered in this manuscript as well insight into overall content, which improved the final product we delivered.

We also want to thank the many firms that participated in the 2008 PCPS Succession Survey (our survey update).

Finally, we would like to thank Andrew Grow (our editor) and Martin Censor, Esq (Acquisitions Editor for the AICPA) for making sure this product was the best it could be. Both of them were easy to work with and did a great job of balancing being flexible and forceful in organizing, simplifying and improving our work.

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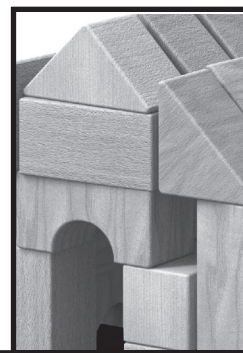
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Bill is CEO and co-founder of the consulting firm Succession Institute, LLC. He has been consulting for three decades to all sizes of businesses, from Mom and Pop operations to Fortune 100 companies, primarily in the areas of organization, automation, and revenue generation. He decided to add the credentials of CPA behind his advisory work and became a CPA in 1986. Prior to his life as a consultant, he worked for IBM in sales back in the late 70's. As an entrepreneur, Bill has founded eight small businesses in the retail, software development, and services sectors.

As an award-winning public speaker, Bill lectures throughout the U.S. and Canada to thousands of executives and CPAs each year. In addition, he has been featured on numerous video-taped and live television programs. As an award-winning author, Bill is internationally published with hundreds of articles and columns to his credit. He currently authors a bi-monthly column called "In the Bill-iverse" which at the time of this printing is distributed by 15 State CPA Societies as part of their Practice Management e-newsletter. Besides being published by various magazines, journals and newspapers, Bill has written a number of books, including the fourth edition of his consulting book. Bill also authored a book on succession called *Securing the Future: Building a Succession Plan for Your Firm*, which was published in July of 2005 by PCPS/AICPA. And as you can see, this book is a sequel to his first book on succession with this material covering Succession Planning as well as a number of best practice CPA Firm Management topics. Finally, Bill co-authored the Succession Resource Center Web site materials for PCPS in 2008.

Bill is an active volunteer within his profession, having served in many leadership roles in the AICPA such as being a current commissioner of the National Accreditation Commission (NAC). He has also served in numerous other roles including being a member of AICPA Council several times, a member of Strategic Planning and Chair of the Consulting Services Committees. On a local level, Bill has been a member of the Executive Board, Strategic Planning, and Chaired several Technology Committees for the Texas Society of CPAs. Additionally, he has been honored by being named as a CPA Ambassador, was presented the Pathfinder Award and served as the Texas Vision Delegate. *Accounting Today* has recognized his efforts by listing him as one of the Top 100 Most Influential CPAs, CPA Magazine has named him as one of the Top 100 Most Influential Practitioners, and Inside Public Accounting has listed him several times as one of the most recommended CPA firm consultants.

Dom Cingoranelli, CPA, CMC



Dom is Executive Vice President of Consulting and co-founder of the consulting firm Succession Institute, LLC. He has been consulting for three decades to a variety of organizations, from professional services firms, to nonprofits, construction companies and Fortune 500 companies. Dom has been a CPA for thirty-five years, and started his own firm in 1976. He ran an office of a local CPA firm located in a rural area of Colorado until 2008 when he joined Bill Reeb to create the Succession Institute, LLC.

During his career in public accounting, Dom had consulted not only with businesses in his CPA client base, but also with other CPA firms. His work also includes assisting project managers with partnering and conflict resolution on large, complex construction projects of over \$300 million. In addition to being a CPA, Dom is a Certified Management Consultant and he earned his MBA with honors from Regis University.

He speaks frequently on management and consulting topics and has made presentations at AICPA conferences, state societies of CPAs and CPA firm association conferences, as well as the Annual Conference of the Institute of Management Consultants—U.S.A. Dom has created CPE offerings on a variety of topics ranging from strategic planning to professional firm practice management. In addition to his CPE courses, Dom has been published in the *Journal of Accountancy*, *The CPA Journal*, *The Practicing CPA*, *CPA Insider*, *CPA Management Consultant*, *Constructor*, *Broker*, and other state, regional, and national media. Many of his position papers can be downloaded from the Succession Institute Web site. Dom has been quoted in the *Dow Jones Wealth Manager*, *CPA Insider*, the *Journal of Accountancy*, and the *Construction Company Strategist*, and he has participated in national webcasts of IOMA and AICPA on CPA firm management and succession planning. Besides this book, Dom is also a co-author with Bill of a book addressing advisory/consulting services for CPAs, and he co-authored the Succession Resource Center web site materials for PCPS in 2008 and the PCPS Trusted Business Advisor website in 2009.

Dom has served in a variety of leadership positions for nonprofit and professional organizations. He chaired the Management Consulting Services Committee for the Colorado Society of CPAs and served on a variety of AICPA committees, with his most recent position being that of Chair of the Consulting Services Executive Committee. He also has assisted as a panel member for interviews of candidates for the CMC designation at the IMC-USA. Outside of accounting, Dom has been active in the heavy construction industry, having received the Associate Member of the Year Award in 2007 from the Colorado Contractors Association. At the time of this writing, he was the Chair of the Associate Member Council (Board of Directors) and a member of the Contractor Board of Directors of the Colorado Contractors Association.

Michaelle Cameron, Ph.D., MBA

Michaelle Cameron is Executive Vice President of Assessment and Learning and co-founder of Succession Institute, LLC. She specializes in marketing research, online course development and 360 leadership assessments. Michaelle has been the internal project leader in developing numerous online surveys for the AICPA, several CPA States Societies and client surveys. She also consults with firms in the areas of marketing planning and practice development.

With a varied educational background, Michaelle brings diverse perspectives to her work utilizing her PhD in marketing from the University of Texas at Arlington, an MBA in accounting from the University of Texas at Austin and a BA in psychology from Youngstown State University.

Besides her work as a professor and as a consultant, Michaelle has co-founded three businesses in the retail, software and consulting industries. Her work as an entrepreneur has given her an important grounding between the theory and implementation of ideas in the workplace. She also has fourteen years of experience in sales, marketing and product development with IBM. During her early tenure with IBM, Michaelle worked in sales, support and executive training. During her later years there, she was a product planner helping design and develop products from inspiration through product launch.

As an award-winning author, Michaelle has published numerous scholarly articles as well as practitioner articles in the *Journal of Accountancy* and *Today's CPA*. She has won awards for both her scholarly and practitioner-oriented writing.

As the chair of Marketing at St. Edwards University, she designed both the graduate and undergraduate marketing curriculum, measured and managed learning outcomes and assessments, created numerous online courses, as well as hired and trained faculty for the department. During her tenure as marketing chair the department experienced significant growth in enrollment while also substantially increasing the SAT scores of the students admitted to the program. Michaelle was a member of several creative curriculum development teams that constructed innovative graduate programs addressing the business of technology, including a digital MBA and a concentration in E-business.



Chapter 1



Succession Introduction

Introduction

A few years ago, a news account detailed a plane crash that took the lives of three prominent Colorado businessmen. This is the kind of news that no one wants to see or hear because it stirs up issues dealing with mortality, life balance, stewardship, and fate, just to name a few. When we are younger, we respond to this information as news but don't really see it as something that will happen to us. As we get older, we not only continue to read stories such as these about people we don't know, but, more and more, sad stories regarding unexpected death and disability center around our friends and acquaintances. Although this barrage of information heightens our awareness of how quickly life changes around us, it is still surprising how many of us ignore the possibility that this kind of tragedy could happen to us. We live in the moment. We feel fine today. We think health issues are analogous to traveling down a straight road that meets the horizon you can see 100 miles away. In other words, we believe we will have plenty of time to see, plan for, and react to any major changes coming into view on our horizon.

Unfortunately, in the work we do with organizations around the country, especially given the graying of the baby boomer generation, we increasingly encounter abrupt, debilitating health issues that devastate organizations. The problem is that we see this as a personal

issue rather than an organizational one. All too often, we don't look at our firms as entities that we need to protect. We obtain insurance—life, disability, or both—to assist the family member affected by illness, but we usually stop there and don't spend the time that is necessary to plan for extending the life of the firm to ensure that it remains a going concern for the surviving partners, employees, and clients.

Clearly, we believe all CPA firms need to plan for succession. Unfortunately, the statistics, which we will cover in detail in chapter 2, indicate that our profession is poorly equipped to respond to potential threats. As professional service organizations, we live and work in a business that has as its inventory our time and relationships. As soon as an event happens that immediately limits a firm's inventory, the value of our organization is at risk. This risk can be mitigated, or at least minimized, by putting together and implementing plans to address both expected (normal succession management) and unexpected (crisis succession. management) succession.

Orderly Succession Planning

This is the type of planning that probably comes to mind among most CPA firm owners, unless they have recently encountered a crisis in a key position. However, it entails more than simply working out buy-sell agreements and finding ways and means to fund them. In the broadest sense, this refers to the people and process aspects of succession planning. On one end of the spectrum, the partner group, led by the managing partner, should be identifying future leaders, identifying future skills and competencies, assessing their fit with needed competencies and skills, and developing plans to close any skill or competency gaps. On the other end of the spectrum, the partner group should be implementing the following processes and procedures:

- Instilling accountability
- Establishing clear lines of authority, powers, and limitations for governance and positions within the governance structure
- Creating standards of performance
- Institutionalizing the intellectual capital or knowledge of the personnel
- Building infrastructure
- Developing roles and responsibilities

All of this work is necessary so that transitions in leadership are seen and felt as interchangeable personalities rather than changing cultures and operating environments.

At the end of the day, orderly succession is about creating a system that supports change without change. Organizational change should always come from strategy redirection, not vacancies. Orderly succession planning and crisis planning strategies are tools firms should be using to protect their organizations' value and future.

Crisis Succession Planning

This is the planning an organization needs to do to prepare for an unexpected vacancy in a key position resulting from a sudden departure, death, or disability. It helps answer the question, “What if a truck runs over [fill in the name] tomorrow?” Unfortunately, this type of planning is usually done at the time of the incident rather than as advance preparation. Partner groups, led by the managing partner, should periodically review their firm’s key positions and look at who is available to fill in—at least temporarily—for the incumbent in the case of an unplanned vacancy. In addition, the process focuses on developing “seconds,” or replacements, for all key positions.

In addition to identifying potential candidates to fill key positions, an organization should ensure that job descriptions of the key positions are updated periodically. What about documenting key clients and other external contacts of the incumbent, which is critical information for anyone stepping in to carry out this person’s duties? Is that information updated periodically, as well? Does anyone else in the firm know where to find this documentation if it is needed? Does anyone else in the firm actually know any of these people?

The point is that crisis succession planning, which, in our experience, is the type of advanced planning least often performed by CPA firms, should outline processes to constantly capture the necessary information and require that almost every position, especially key positions, have successors, or “seconds,” identified and in the process of being groomed. Although this sounds like a negative and morbid approach, realize that developing this kind of organizational chart of “seconds” and establishing career paths for your people is simply good personnel management.

Identifying Future Leaders—Choosing Successors for Key Positions

When Jack Welch of General Electric (GE) finally named his successor, two other highly experienced and talented managers also were waiting in the wings. The two also-rans did not need any sympathy, however. Within days after the announcement, both took CEO positions at other companies. The GE experience highlights a critical principle of management: if managers are doing their jobs, they are constantly developing key people to replace them. Jack Welch didn’t have just one possible successor; he had three.

As the baby boomer generation continues to mature, management succession and business succession planning are becoming more important for all businesses, and CPA firms certainly are included here. However, many companies now face, or will face, a crisis in leadership because top management has not developed a successor(s).

The Society for Human Resource Management¹ recently summarized the results of a survey of key executives from a variety of businesses regarding their plans for selecting their successors. The survey showed that many of them felt they would have to look outside their

¹ SHRM. 2006 *Succession Planning*, SHRM.

organizations for their successors. There is something wrong with this picture. Why do so many businesses have to look outside their organizations for leadership talent? Is it because all of these companies only know how to hire losers, or is this phenomenon occurring because most leaders only know how to develop themselves, so they stifle the growth of the people who work for them? Is it because these companies have already ruined the talent who works for them, so they have to look outside to find untainted leaders? Is it because we only recognize leaders who look exactly like us and we don't hire these people or can't retain them because they clash too often with us? Could it be that we overlook the talent right under our noses?

If most companies feel they need to hire someone from outside their organization, then doesn't it stand to reason that at least some of our people might be considered capable candidates for taking over top slots somewhere else or branching off on their own? The perspective that the talent-grass is always greener outside of our firm is common. Just as common is the idea that we can solve our missing talent needs if we can steal people away from, or merge with, another firm to gain access to its young leaders. This approach makes sense if you start with the premise that every other firm in existence must be better at developing future leaders because you have none, and it looks like they have plenty. The sad part of this story is the number of firms that have bought or merged with other firms for leadership only to find their new people are not any better and sometimes are worse than the talent they already have.

What is ironic to us is that most partners of small to midsized firms actually left the larger firms they worked for because they were either not recognized as the future leaders they believed themselves to be or not graced with the decision-making authority they believed they deserved. The vast majority of these people then went on to create and develop very successful firms of their own. You would think this group of neglected or overlooked CPAs would be overly generous about looking for the potential in their people; however, this is not so. If there is a consistent theme song played among all executives and partners, it starts with these words: "Younger people today just don't _____ the way we did/do." You would probably have a hard time coming up with a phrase to fill in the blank that we haven't heard many times before. Unfortunately, this same song was likely sung by their executive predecessors and the predecessors before them—probably since the beginning of the human race.

The sad part is that most leaders have an exaggerated perspective of their skills, don't realize how they are stifling the development of those below them, overlook or minimize the talents of their up-and-coming leaders, or some combination of the three. In numerous circumstances, we have helped identify plenty of leadership talent in organizations thought to be barren of this skill and competency. Although there is no question that these young leaders needed to be developed and nurtured, once we could get past existing management's prejudices, these people quickly blossomed. Know that, typically, the first step toward supporting the emergence of new leaders is having the existing leaders get out of the way.

Other, more recent surveys have shown that the success rate for outsiders brought in to run a company is extremely low: less than half succeed in their new positions. Several causes were identified for these failures, including a poor match of core values, lack of fit with the

corporate culture, and inability to build coalitions with others inside the company. These types of disconnects are even more pervasive, in our opinion, within CPA firms. Hiring a managing partner or CEO from outside the firm, either a CPA or non-CPA, is not an option we have seen work.

Firms in public forums espouse the success of hiring non-CPA executive management; however, to our knowledge, those positions ultimately fail as soon as that managing partner or CEO tries to hold any of the senior partners accountable to the organization. CPAs are good at handing off administrative management to non-CPAs, but, in the end, CPAs seem to only trust and hand power over to other CPAs who have proven themselves as outstanding client service partners. Therefore, most CPA firms are faced with developing their own in-house successors.

Why CPAs Don't Develop Successors

Many CPAs can cite a litany of reasons for not actively grooming their successors. Reasons cited often include something similar to the following statements:

- I don't have time because other business demands preclude it at this time.
- I have plenty of folks here who might be candidates but not any legitimate candidates now; I will watch to see who develops.
- We have a number of partners in our organization, but they are technicians and not suitable for leading this firm.
- I am not planning on retiring for 5–10 years, so there is no reason to pursue this just yet.
- I plan on selling the firm to another CPA firm because I don't have the leadership talent necessary to pay off my retirement.
- I plan on selling the firm to another CPA firm because my partners will run this business into the ground once I leave, and I have no assurance that I will ever see my retirement paid in full.
- I plan on working until I don't want to do this anymore and then see what my options are.
- My son or daughter will work here for a while and step into the position, so I don't need to worry about it now.

Of course, many unstated reasons exist for not developing successors, such as the following:

- The need for control. Many CPA firm owners do not want to give up the authority required to develop decision-making skills in their people.
- Firm owners may have the following view: It takes money out of my pocket to develop overlapping talent. I have the skills we need for now, and when the time comes for me to retire, I will see who is out there who can take over my firm.
- However, firm owners may decide the following: I don't want to develop some young partner to take over because he or she may get tired of waiting and try to force me out before I want to leave.

- Another common viewpoint is the following: I like being the go-to person and running this firm my way. I don't want to build successors; I want to surround myself with people who can make my life easier.
- Senior owners may not have developed any significant outside interests and don't have a clear idea of what they will do with their time if they retire. So, they don't want to create any pressure to move on.
- Some firm owners may even be having trouble dealing with their own mortality.

Getting Started in Succession Planning

CPA firms can take the following four critical steps to begin dealing with the people issues associated with succession planning:

- Clean up your firm's operations
- Develop your own management skills
- Manage the performance of your subordinates
- Develop the management skills of your subordinates

We will spend a lot more time during our succession journey discussing ways to clean up your firm's operations in chapter 3. For now, just know that our experience shows that whatever ails your organization is a direct result of the actions of the partner(s) over the last 5–10 years. We commonly use the phrase “the fish stinks at the head” to convey the idea that your firm is exactly the way it is because you built it to be that way (the good and bad processes, good employees and bad ones, and so on).

Develop Your Own Management Skills

A management gene does not exist; management is a learned skill. Any CPA firm owner or manager can improve his or her abilities in key areas. CPAs must model appropriate behavior and skills if they expect to develop them in their people, and for people to be able to model the appropriate behavior, they often need to first take a hard look at their perceived behavior. For those who wish to better understand their management blind spots, as well as identify opportunities for personal growth, we recommend a confidential statistical validation of skills through instruments like a 360 degree feedback survey. A variety of such instruments are available, such as our QuadLead instrument for CPAs, otherwise known as the Succession Institute Managerial Leadership Assessment.[®] These instruments measure skills in a number of areas, such as decision making, leadership, delegation, performance feedback, and interpersonal skills. By choosing one or two areas to work on at a time, managers can readily make incremental improvements in their behaviors. By adopting an incremental approach, managers can make changes without a lot of disruption to their organization or themselves. Another way to look at this is that it is very difficult to be effective at managing others if you are not aware of yourself, your actions, and how you are perceived. Awareness is the first step in learning how to better manage yourself.

In addition to the broad, managerial skills assessments, CPAs can use a variety of special purpose assessments to help increase their effectiveness. For example, one such assessment

is the Situational Leadership® suite of tools created by the Center for Leadership Studies to help executives learn how to properly delegate. For CPAs who wish to learn how to become more effective delegators, supervisors, and developers of people, the tools are available; CPAs just need to avail themselves of them.

Another area of improvement is often the most overlooked for small firms. It is the idea of specialization. We are not referring to service specialization, such as personal financial planning, business valuation, and so on; rather, we are talking about roles and responsibilities. For example, a solo practitioner has to do everything, from being the partner in charge of client relationships to serving in the capacity of technical partner, doing the manager-level work, and fulfilling the duties of the staff and firm administration (acting as the ultimate hunter). Often, as firms grow and additional people are hired, the hunter just keeps on hunting, hoping that everyone else will catch on and pull their share of the load. Although this approach works, it becomes less effective with each additional hire. To make the firm better, faster, and stronger, the hunter should first redefine his or her roles and responsibilities and then do so for everyone else. Each time another person is added, more specialized roles should emerge. So, rather than trying to teach everyone to do everything, all employees can become more effective more quickly by focusing on a constantly narrowing set of duties.

For example, take the role of a partner. You would think this role would be the first one defined in every firm. Actually, our experience is that it is the last. In most firms, partner usually means “I now can get away with doing almost anything I want.” Appendix A, “Partner Roles and Responsibilities,” found at the end of this chapter, describes partner roles and responsibilities. We have developed this as a separate document because it is the kind of information that you will likely want to pass around your organization and then modify to fit whatever your organization believes makes the most sense. We also attached a similar tool as appendix B, “Technical Versus Supervisor Managers” outlining the differences between supervisory versus technical managers.

Manage the Performance of Your Subordinates

Part of developing subordinates involves managing their performance. This means that a CPA firm owner helps employees set goals and achieve them. It also means that he or she holds the staff accountable for results. Savvy CPAs use employees’ mistakes as tools for learning and development. They encourage people to take measured risks to improve themselves, the organization, and their people. At the same time, they do not tolerate inertia or excuses.

Performance management requires CPA firm owners to delegate to their managers and provide appropriate direction, support, and follow-up to them. In turn, the managers need to be able to appropriately delegate to their direct reports. An owner or manager can help improve subordinates’ performance by routinely meeting with them individually to discuss progress toward goals and ways to remove barriers to goal achievement. To do this effectively, the owner or manager must have a system to monitor subordinates’ goals and commitments.

This also means the owners or managers have to treat the job of developing people seriously, which is as important as doing any technical work. In the professional service business, people are our inventory (their skills comprise the collective intellectual capital of the firm that helps differentiate it from the competitors). The more quality inventory a firm has to sell, the more profitable the organization and the higher the client service.

Developing quality inventory (skilled people) doesn't happen without a concerted effort and a firm culture focused on the importance of making those people around you better, faster, and stronger (which means a significant amount of partners', managers', and senior executives' time is spent training, teaching, and coaching the people who report to them). As we stated before, a management gene does not exist. This is all very learnable, and if the owners and managers of many small to mid-sized firms devoted time to building the firm's intellectual capital by working on these skills, they would benefit from them immensely.

Develop the Management Skills of Your Subordinates

GE, which is known for its ability to produce quality management teams, conducts extensive in-house management training for its people. Senior executives play a key role in those training sessions. Certainly, CPA firms don't have anything close to the resources of GE, but much can be done very inexpensively to continually improve the management skills of their subordinates. We all have three basic resources: money, time, and skill. Your most scarce resource will drive how you put together your training and development programs. If money is your most scarce resource (which is the case for most small firms), then your programs will have to be put together by (1) allocating time for key people to focus on quality and constant internal training and (2) developing better on-the-job training by letting your more inexperienced people shadow employees who are proficient in their work.

Even this isn't enough if the people who are supposed to be passing on the knowledge are not rewarded for the development of those around them. One of the common messages we tell partners, managers, and senior executives in CPA firms is "If the only person you can develop is yourself, you're not worth nearly as much to this organization as someone who can develop those around them." In other words, a person who can make others better, faster, and stronger creates leverage for their firm and, therefore, should be the first in line for promotions and financial rewards. We need to be supporting a culture that values those people who make others better. In most CPA firms, the value system in place is built around those people who can personally produce, which tends to put a huge priority on cranking out more work versus cranking out better inventory (more highly skilled personnel).

Developing Your Team

Who are the likely in-house candidates who can be groomed to fill key positions over time? In many firms, some high potential players seem to be natural choices, but don't overlook any of your top talent. With a little development, appropriate training, and coaching, many

people can quickly blossom into leaders. Occasionally, you will find people who don't seem to aspire to high level positions within your firm. Our experience is that most of these people don't aspire to those positions because what the firm is offering doesn't make sense.

The young people looking at the leadership offer on the table only see the following:

1. A dysfunctional firm regarding accountability
2. A debt requirement to buy out the senior partner(s) that doesn't make economic sense
3. A partner group working way too many hours for the rewards they are earning
4. An infrastructure of talent way too thin to support the loss of talent and charge hours about to retire from the firm
5. No ability to be able to retain and grow the clients, maintain the income stream, maintain and grow the profits, and sustain the organization based on the way it currently operates

The preceding conditions are avoidable, however. It just takes a conscious effort on the part of the owners to do something about the underlying causes. Some of these causes are attributable to unconscious business decisions the owners have made over the years and some are attributable to consciously chosen options, such as the way the firm is owned and managed and what behaviors it rewards. As we cover all the material in this text, we'll be making references to "eat what you kill," or superstar, and "building a village," or operator, models of doing business. These concepts are covered in depth in *Securing the Future: Succession Planning Basics*, but we have included a brief discussion in appendix C, "Effective Operating Models for Running a CPA Firm" at the end of this chapter as a refresher.

Once these issues have been adequately addressed, people come out of the woodwork vying for ownership options. However, there will always be a remaining few talented people who just want to do their job and stay away from key leadership positions. This is actually great for the firm. Nothing is better than a hard working, loyal manager-level person who just wants to do his or her job. The real virus that destroys happy and functional organizations incubates the first day a partner decides to keep a person on board who does not have what it takes to be a good team member, won't pull his or her share of the load, or both. The most common excuse from partners about why they keep poor performers is "He or she is slow, does poor work, and is a pain to work with, but we have too much work to do to let him or her go." The next time you catch yourself saying this, just realize that you are, in most cases, making a terrible short-term decision that will create numerous negative long-term side effects. Instead of creating a highly functional team, you are creating dysfunction. You are teaching all of your people that you will cater to the underperformer, and as a special reward to your top performers, they will get to pull the wagon for the underperformers with little financial incentive in order to make up for your inability to lead and take action.

Teams are fragile, and good teams are rare. So, if you want to develop a quality team with staying power, you have to make hard decisions that protect and nurture the team you have, as well as the one you are trying to build and sustain.

Start Now

Depending on your firm and your people, it can take a minimum of three to five years to develop someone to take over. Note that succession is rarely about just one position—it is usually about playing an organization-wide game of musical chairs. For every person you move up, someone has to fill the void created by a promotion. Creating a viable succession process can take more than five years because succession affects the firm at every level. Although one person might be ready to step into a key role in the firm, if that same person has not developed a replacement for his or her current position, the promotion solves one problem and potentially creates another one.

Although the concept of succession is simple, it takes time to work through all of the moving parts and put together a plan to manage them. The longer you delay, the more likely you will be ready to only make the first move of a multi-move play. This will not end well and will likely result in fewer options for you to consider. Life is about options—creating options and making choices among those options. The fewer options you create, the more you might find yourself trapped by the choices that remain.

Our profession is undergoing a great deal of change right now, and we believe it will undergo significantly more change as the baby boomer generation starts to retire in force. We believe that many CPAs will soon find themselves putting their single biggest asset—their business—at high risk if they don't start planning now to compensate for these changes. So, before we get into the various approaches we have devised to help you protect that asset, we want to spend a little time covering the changing landscape of our profession.

Appendix A

Partner Roles and Responsibilities

We thought we would share with you our general definition of a partner's roles and responsibilities. Although we are not suggesting that this is the only effective definition of a partner's roles and responsibilities, we are suggesting that it is, at the very least, a best practice definition. Generally, here is what we expect from the partners:

- Client account management, which includes
 - maintaining client satisfaction with, and loyalty to, the firm.
 - continuously updating their understanding of clients' priorities.
 - meeting with "A" clients at least four times a year and "B" clients at least twice a year.
 - identifying additional services that would be beneficial to those clients.
 - providing a high level oversight of the work performed for those clients.
 - billing and collecting fees.
- Pass down the regular contact and billing and collecting responsibilities of "C" clients and, potentially, some low level "B" clients to managers.
- Maintain a constant connection with key referral sources, meeting with them on schedules similar to "A" and "B" clients.
- Leverage the work being performed for the clients you manage. Partners do client management first, managers do project management first, and the staff does the detail work.
- Focus on developing people and building a right side up pyramid (covered in-depth in *Securing the Future: Succession Planning Basics*).
- Implement firm strategy.
- Price projects above firm-established, minimum levels of realization, move "D" clients up or out, and stop clogging the firm with bad work.
- Actively promote and comply with firm-wide initiatives.

Clearly, in order to live up to this role, partners have to spend time meeting with their top clients and listening to and trying to understand what keeps them awake at night (that is, understand the concerns and opportunities they are trying to address at this time). The importance here is not about selling services (which you will), it's not about looking for services your firm offers (which will happen), but about uncovering issues, regardless of whether you are able to resolve them. The great news is that simply by understanding the needs of your clients, you can live up to our profession's mantra of being your clients' most trusted advisor. You become the first point of contact when your client has a business problem. Most CPAs are already the first point of contact regarding a financial problem, but that is far different. By understanding what is keeping your clients awake at night, you put yourself and your firm in the place of most potential to help them, refer other professionals to help them, or just be supportive. All of this builds stronger client loyalty, as well as higher satisfaction.

In order to fully understand the roles previously outlined, we need to take a minute and define what we mean when we mention “A,” “B,” “C,” and “D” clients. The following narrative should shed additional light on the partner roles previously identified.

- An *A* client is often defined as one of 15 percent to 20 percent of the clients who make up 70 percent to 80 percent of the firm’s revenues. If you sorted your clients by revenues for last year, you would quickly identify those clients who generated substantial fees for your firm. An “A” client is one who you are probably adequately serving, one who will continually have new projects for you to do, and one who generates sizable revenues for your firm.
- A *B* client is one who you are most likely currently under-serving but who has an opportunity to generate sizable revenues for your firm. For example, you might have a business client for whom you only do tax returns. However, based on what you know about the business (for example, it might be \$5 million in size or have 100 employees), you could easily provide them with thousands of more dollars in needed services.
- A *C* client is a client who does not have much additional service opportunity other than what you already do, and the revenues generated are small. However, they are good clients, do not have complex situations, pay you on time, pay average or better fees, and are pleasant to work with. The best description of this group of clients is that they are your typical individual tax return only clients. Don’t confuse the “C” rating with school and assume they need to become “B” clients to make the grade. A firm can have all “C” clients and do very well.
- A *D* client could seemingly fall into any of the previous classifications; however, these clients present at least one of a number of possible problems. They most likely are unprofitable to the firm as a result of poor rates, realization, or utilization. They also might be hard to work with because they are abrasive, late payers, never timely so they always create scheduling problems, always want special accommodations, require services that are too difficult to provide (for example, this client is the one governmental audit you perform, which is very inefficient work for you), or only pay your last bill as an incentive for you to start their next project. None of these issues alone automatically classifies someone as a “D” client. For example, you might have someone who always pays you late, but you charge premium fees for their work, which makes him or her an acceptable client. Also, someone may constantly negotiate fees but, nevertheless, involves you in big projects that are profitable. Generally speaking, most firms quickly know who falls into their definition of a “D” client. At the end of the day, you do not want any “D” clients. This means that your objective is to either find a way to convert them into “C” clients or better or introduce them to your fiercest competitor. In the latter instance, these clients can then waste your competitor’s resources instead of yours.

The most fundamental role of a partner and, in some firms, the managers is centered on client relationship management. Here is more information about this critical function:

- For “A” and “B” clients, a partner or manager should be assigned as each client’s relationship manager.
- Quarterly update meetings should be scheduled with all “A” clients and, at the least, semiannual meetings should be scheduled with all “B” clients. At some point, these meetings will become billable, but in the beginning, the investigation necessary to fulfill the role of relationship manager can be done through a lunch outing.
- Each relationship manager, through regularly scheduled meetings, should be able to rattle off their clients’ top 5 priorities for the coming 18 months. Client relationship managers should know what is keeping their clients awake at night (that is, the concerns and opportunities they are trying to address at this time). By the way, an important part of this process is to uncover issues, regardless of whether the firm is able to resolve them. Think of the relationship manager as the general contractor. For issues

that the firm can address, the contractor brings in his or her own people to perform the work. For issues the firm cannot address, subcontractors (or friendly outside professionals) are referred to provide the necessary assistance.

- Referral sources should be rated, as well as clients. “A” and “B” referral sources should have a relationship manager assigned to each of them with the expectation of regularly scheduled contact.

In our opinion, the firm is in danger of losing “A” or “B” clients, or both, when a partner or manager in charge of these relationships cannot at least articulate each client’s priorities. Although the firm will not likely incur these losses overnight, you can bet that critical client needs that go unserved for too long will attract attention from competition. With each passing day and with CPA firms continuing to broaden their scope of services, that competitor is likely to be another CPA firm.

Also noteworthy is that we continue to be surprised by how many firms expect professionals to refer business to them but do not reciprocate. Providing a referral for a needed service helps the client (they get access to needed skills), helps the firm (referrals out create more referrals in), and underscores why the CPA is the client’s most trusted advisor (because the client can easily access the relationship manager’s professional network).

If a client is classified as “D,” then the client relationship manager of that client needs to develop a strategy to convert them into “C” or better. That strategy could be as simple as the following:

- We will bill them at 95 percent of the standard rates this year and see whether they want to remain a client.
- We will transition this client to one of our senior staff to manage and bill because the client’s needs are better suited to the senior’s experience level and billing rate.

Alternatively, the strategy could be as drastic as the following:

- The partner needs to inform this client that the account must be paid current and kept that way or the client needs to find another accountant.

We don’t believe in firing clients; we believe in making the client relationship manager and the client accountable to sustaining a profitable relationship. If the client wants the relationship to be one sided (in other words, profitable only to him or her), then adjust the policies and billings to where they should be and let the clients make their own decisions. Don’t be surprised by how many of your “D” clients have become that way because you created an operating environment that steered them in that direction.

As you can see, our message is that partners and, in some firms, managers need to take their client relationship management responsibility seriously. In most firms, this role is purely an economic assignment. We believe the relationship manager role is the foundation of the firm’s success and should be formalized with CPAs being held accountable. For example, consider the tax partner—the walking tax library for the firm. When this person is the relationship manager for a client, he or she cannot decide to only talk about tax-related issues. If that tax partner is the partner in charge of a client relationship, then he or she is obligated to understand that client’s top priorities, both strategically and tactically, across all services all the time. He or she also is obligated to report that information to the firm in some systematic way. Finally, he or she is responsible for finding ways to help the client when possible by extending firm services, referring work to other professionals, staying involved as the client’s advocate, and so on.

When you are a client relationship manager, regardless of your technical specialty, you take on the role of being that client’s general contractor for professional services. If you are unwilling to fulfill this role, then you shouldn’t be a client relationship manager; you should be a technical partner.

Given that last comment, we now need to define the difference between the role of client relationship partner and technical partner.

The simple definitions of both are as follows:

Client relationship partner. This is a person in the firm who is assigned the duty of understanding the needs and priorities of specific clients and helping them address those needs through the following:

1. Providing advisory services to assist the client in putting together an action plan or approach to solve those problems
2. Providing additional firm services that can directly resolve the identified issues
3. Referral of other professionals who can provide the necessary assistance
4. Simply being a concerned, objective third party who listens and has an interest in them and their business

Technical partner. This is a person in the firm who is highly technically competent and his or her professional focus is on the following:

1. Being the firm's preeminent resource in specific technical areas
2. Providing advice and counsel to other partners (and staff) in those technical areas
3. Taking on the oversight and project management of the firm's most complex technical work
4. Exercising oversight of quality systems, processes, and training to ensure technical standards are maintained regarding the firm's work product

The question we always get at this time is, "Can a partner be both a client relationship partner and a technical partner?" Our answer is "Yes." As a matter of fact, for firms with less than six or seven partners, that should describe every partner. As firms grow larger, they can begin to afford the overhead of maintaining technical-only partners. Unfortunately, the reality of most CPA firm partners is that they provide lip service to their role of client relationship partner and bury themselves in their role of technical partner.

So how do you know who is living up to their obligation of being a client relationship partner? Just walk up to any partner, identify one of their "A" clients, and ask him or her to list that client's strategic or tactical priorities for the next 18 months. We are not just referring to that client's tax or audit priorities but their priorities, holistically, as an organization or a person. If your partners can't answer this question off the top of their heads or after quickly referring to recent notes, then those partners are not fulfilling the duties of a client relationship partner.

How do you know if a partner is a technical-only partner? Technical-only partners tend to

1. always default to the work on the floor (in the office) as being a higher priority than meeting with clients.
2. focus primarily on cranking out work product.
3. only talk to their clients about the service they specialize in providing (for example, a tax partner might fully service a client's needs in the tax area but ignore that same client's needs in other areas).
4. emphasize the development of their technical skills and have little regard for soft skills.

When small firms start allowing partners to become technical-only partners, they create a long-term success and profitability problem. Why? Because technical partners are just managers with more experience. If the partners are so busy cranking out the work, then who is

- taking the time to make sure their clients are satisfied and being adequately serviced?
- finding new opportunities to help grow the firm or, at a minimum, replace the natural client attrition that will occur due to no fault of the firm (death, sale of the business, and so on)?

- developing people so that the partners don't become too important in getting out the daily work product and so that the firm has a strong infrastructure of talented people at every level in the organization?

It is poor firm strategy to judge satisfaction and service solely based on whether clients call to complain or to ask you to forward their files to some other CPA firm. Technical partners tend to wait for the phone to ring before help is offered and, even then, usually only offer help when the request for service falls into their specialty area. How can we look in the mirror and see ourselves as our clients' most trusted advisors when the only time we advise them is when they call us, or the only questions we want to talk about are their tax returns or financial statements? Client relationship partners need to proactively seek out what is "keeping their clients awake at night." They care enough about their clients as a whole that staying in touch has a higher priority than personally doing their work.

Small firms rarely have the luxury of having technical-only partners. So, that means that small firms have to focus on developing good technical managers (even as a solo practitioner, you should think hard about starting to develop someone to fill a manager-level position over the next five years so that you are better positioned to well serve your clients). The managers should be groomed to take on the responsibility of managing the "C" level and maybe some low "B" level clients. They also should be the project managers for much of the "A" and "B" clients' work. This is the type of organization firms need to build to free up the partners' time so they can do those things that only partners can do.

Appendix B

Technical Versus Supervisor Managers

Types of Managers

The first thing we would like to challenge is that the title *manager* is too broad. So, we break it down into two common deviations in CPA firms: the technical manager and the supervising manager. We make a similar distinction in appendix A “Partner Roles and Responsibilities” regarding the client relationship partner and the technical partner.

Technical Managers²

Let’s start by introducing the technical manager position. The way we see this typically work in firms is that technical managers are people who are known to be technically competent, produce quality work, manage client projects (not develop people), and crank out work product all day. They usually are the kind of people you can hand a project to and never have to worry about it again because you know it was done correctly. These people typically have the title of manager purely because their experience and billing rates warrant such a status level, not because they actually manage anyone.

In many environments, you will find some of the people who fill this role are good with client communications but, all too often, are terrible in their interaction with the staff. The common joke is that everyone inside the firm pushes work under their doors to avoid having an encounter with them. These people tend to hold themselves to a high technical quality of work standard and are frustrated by the incompetence that surrounds them. They get away with this condescension partially because they do superior work and partially because they are among the minority of personnel to which partners will actually delegate work. Because of their attitudes regarding those that surround them and because they expect the other employees to take initiative like they have done to figure everything out on their own, they tend to believe in the superstar model (allow the crème to rise to the top on its own, leverage them, and ignore the rest).

At this time, we want to make several points about the technical manager position:

- These people are very valuable, either in full or part-time roles.
- These people do not manage people; they manage projects, cranking out work. Although they may use other staff to help them on their projects, they rely predominantly on themselves to get the key work done.
- Some technical managers have midlevel client relationship responsibility.
- Technical managers should be rewarded for their superior personal work product and client project management.
- For those few who everyone really wants to avoid because they are so condescending, stop that behavior. Although we want to create an environment where everyone’s skills can be best utilized and although technical managers can be put in positions to mainly crank out the more complex technical work, they cannot be allowed to create fires throughout the firm because of their lack of emotional control or respect for those with whom they work.

² See also *Securing the Future: Succession Planning Basics*.

Supervising Managers

Now let's talk about supervising managers. It should be no surprise that a supervising manager actually supervises and develops the staff. Most firms handle staff management like a resource matching game. For example, consider a firm having two managers and four staff. The typical approach is to put the four staff in a pool and the two managers in a pool and have everyone assigned to manage everyone (or, actually, no one assigned to manage anyone). Although nothing is wrong with pools, even with pools, each person needs to have someone identified as being responsible for managing his or her career and development. So, for firms that buy into this, the common response then shifts to assigning two staff to each manager to divide up the work. Dividing up work is logical but, in this straightforward case, most likely inefficient. Simply put, supervisory managers can manage many people, certainly six or seven and maybe even eight or nine. At some point, span of control is compromised. Ten is a common number touted as an excessive number of direct reports. However, whether that number is truly excessive depends on management's expectations of that manager relative to those people, as well as the skill level of the people being managed and the complexity of their work. Another time consuming factor is the administration and support required to manage employees. So, don't make every manager get involved in the employee evaluation, raise, bonus, and development process just to spread out the workload. Supervising people is a skilled job, and it takes time to learn the ins and outs of the process, HR issues, and so on.

Unlike technical managers, these people should default to getting work done through and with others rather than by themselves. Although supervising managers should be held accountable for their own personal production (albeit a somewhat lesser target than their technical manager counterparts), the production of the staff below them is their real focus. This means that the job of supervising managers includes scheduling the work; breaking projects into bite-sized delegable work; training and mentoring their people; and queuing up work, when necessary, for the technical managers, as well. To summarize, supervising managers

- are responsible for managing and developing the staff.
- schedule the work and make sure everyone who reports to them is busy.
- constantly check the work product of the staff.
- identify technical subject areas that their direct reports need to better understand and then provide the necessary training or coaching so they continue to develop.
- know that although they can do the work faster themselves, that is not their job. It is to find a way to plan the work, break the work down as necessary, review the work, and provide feedback and training to their subordinates about the work they have done.
- conduct employee evaluations, interview technical managers to get input for use in their evaluations (because the technical managers manage supervisory managers' staff when they work on technical managers' projects), develop and manage their staff's career paths, fight with the partner group for appropriate promotions and raises for their staff, and so on.
- have the responsibility to keep their subordinates busy before they take on the overflow work. Supervising managers should be rewarded more for the achievement of those who report to them than for their own personal production (assuming the supervising managers meet certain minimums).

Every firm needs both technical and supervising managers, but it is important to create a clear distinction between each of the roles. FYI, good supervising managers are more important to a CPA firm's future success because they are developing the managers and partners of tomorrow. Technical managers are more important in maintaining today's project quality and timeliness. However, we suggest that firms make it clear that the fastest road to promotion is through the supervisory manager position. Why? Simply because those who are really good at just developing themselves (technical managers) provide less leverage and profitability for the firm than those who can develop themselves, as well as those around them.

Assuming you make this distinction known, you may be surprised to find some people you have tagged as technical managers want to work on developing their skills managing others because of the status given to this position. This is great if this happens, but you need to make clear what you expect and monitor them closely to ensure they are providing the necessary training and coaching to those who report to them. At the same time, our experience is, once we discuss the distinction between the technical and supervisory manager roles, many people will be relieved and will declare themselves to be technical managers despite the reduction in status because they are so much more comfortable and satisfied working when their focus is on managing projects rather than having to develop people. Please don't misunderstand us; technical managers will continue to have promotion and partner opportunities, albeit on a little slower path.

Supervisory Managers Should Be Full-Time

Because of our profession's staffing shortage, firms everywhere are leveraging their production capacity by utilizing a highly talented part-time labor pool. Although we believe that every firm should be imaginative about creating an environment that will attract these part-timers, it is important that they do not fill the role of supervising managers. Unfortunately, many firms have told us that their best supervising manager candidates ("best" being the person with the attitude and aptitude to manage people) are among their part-timers. However, here is what we commonly see happen:

A part-time manager works three days a week (let's say, for this discussion, Monday–Wednesday). Projects come in, are scheduled, and delivered to the staff to work around the part-timer's schedule. Clients call in on Thursday, Friday, or Saturday and change their deadlines; the staff gets stuck on a certain phase of a project; or a project encounters some last minute problems as it becomes due. Then, that work falls to a partner or another manager to handle who has to be brought up to speed and drop everything he or she has planned to get this crisis done and out the door on time.

Some people would take the position that this should not be that big of a problem because a part-timer working Monday–Wednesday is at the firm more he or she is gone (because he or she is on three days a week and off two days). However, the real hurdle is a combination of both a timing problem and a capacity problem. As for timing, that is easy. Fires occurring on any other days beside Monday–Wednesday have to have someone else step in to act in the role of supervisory manager (consistently making sure that the work is being broken down so that the less experienced staff can do it, the staff are doing good work, the firm is taking advantage of every opportunity to train and develop these people, and so on). Second, because part-timers are just that, they also have a capacity problem.

For example, if something comes up late on Friday afternoon, you would expect your full-time worker to come in and handle it on Saturday. Not so of your part-time worker. If something occurred late Tuesday evening, the part-timer would likely already be gone. But even if the part-timer was still there, because he or she would only have Wednesday available to work that week, his or her time may have already been so tightly scheduled that even if he or she gets this situation resolved, pushing off his or her planned Wednesday work until Monday might not be acceptable to another client.

The point is that there are too many times when either timing or capacity availability from your part-time workers is incompatible with the needs of the clients. Finally, the toughest hours for the staff are not those between 1 and 30 but, rather, those hours between 45 and 60+ when they are operating in overload. It is unfair for the staff to be managed career-wise by someone who is never around to see them operate under stress or when they are having to burn the midnight oil to get a key project done.

For this reason, part-time experienced workers should almost always be put in technical manager roles. Because the scheduling of the work queue for technical managers should be overseen by a full-time supervising manager, this allows the supervising manager to easily shift work to compensate for problems that arise with part-time technical managers due to timing or capacity issues. Also, part-timers are best leveraged in either small or large projects because both usually have more flexibility in timing and

capacity. Because of their experience, part-timers also should be used as overflow workers. An example of overflow work might be when a supervising manager has some specific work that needs to be done today, such as reviewing a complex tax return before it goes out, when the partners are all out of the office.

Do exceptions exist? Of course, but they should be rare. For example, two part-timers could share the same supervisory manager's job (with one Monday–Wednesday and the other Thursday–Friday with overflow responsibilities on Saturday). Another example might be someone who can work four days a week with some capacity to handle some overflow work either after normal hours during those four days or occasionally picking up a half day on the fifth day. However, we would only recommend these options when the manager is just too exceptional not to fill a supervisory position.

Finally, part-time technical managers should be left out of all administrative functions as much as possible. Their jobs should be to crank out work and manage projects, not help provide guidance through committee involvement. Firms need to make the best possible use of the limited hours these talented part-timers have to offer and sitting in on management meetings isn't one of them. Obviously, our discussion would not apply to someone who is part-time for a short period and will soon join or rejoin full-time status.

Depending on your firm and its structure, workload, and so on, you will probably be looking at technical managers having charge hour targets of 1,350–1,600 (often leaning toward the higher side of this at 1,500 charge hours or more), but your supervisory managers might have charge hour targets closer to 1,000–1,350 (often leaning to the higher side of this range, depending on how much time they spend scheduling work). Keep in mind, as we introduced previously, a lot of variables come into play about the right charge hour load for supervisory managers, such as the number of staff reporting to them, the level of training of the current group being supervised, the complexity of work queued up, the speed at which the firm wants the staff to develop, and so on.

Appendix C

Effective Operating Models for Running a CPA Firm

For an expanded discussion on operating models for running a CPA firm, consult *Securing the Future: Succession Planning Basics*.

It is our belief that succession is not a big deal for organizations that are well run. We are not referring simply to profitability; we are talking about much more than that.

A foundational principle of a well run firm is an organization that continuously develops its people. Companies need to manage the organizational structure so that it is incumbent on all people to have identified and be grooming replacements for all key positions. When organizations recognize the importance of identifying roles, responsibilities, expectations, accountability, and competencies for all key positions, it becomes easier to fill positions as they are vacated. Why? Because we are not looking for hunters who can do everything, we are looking for specialists (role players).

To clarify this, we want to take a moment and share with you the two most common operational models found within CPA firms. By far, the most common CPA firm model is what we call an “Eat What You Kill (EWYK),” or superstar, model of running a business. This model applies to almost all first generation CPA firms. The founding partners of the firm likely split off from some other firm, hung out a shingle, and started their own business. The model is simple. Because this business starts off small, the owners do everything, from hunting the game to skinning it, processing the meat, preparing and cooking the meal, and eating it. They are the classic entrepreneur (that is, everything from the CEO, sales, operations, shipping, and the secretary to the janitor). Naturally, these firms grow and become successful due to the sheer force and individual contributions of the owners. In a CPA firm, the critical success factors are the book of business they build, the hours they work and bill, and the money they collect.

What is interesting is that the same operating model that makes a firm successful at one size will cause it to plateau and begin to fail at another size. It is a fine line between when the EWYK model is the best success strategy versus when it becomes marginally effective, when it stagnates the organization, and when it becomes a destructive force.

In our opinion, an EWYK model of operations is the best model for a firm to follow during its early years. Why? Because the most pressing strategy of a start-up is to generate revenue, work hard, and manage costs by doing as much of the work as possible yourself.

Even when a firm has 5–10 employees, it is usually still small enough for 1 or 2 partners to bill the lion’s share of the revenue. To offset the rising costs and cash flow shortage of growth, partners typically respond by putting in more hours, but at some point, whether that is at 2,400; 2,600; or 2,800 hours, all that happens is that partners start burning out. At the point where the partners are at full capacity, with every new project, new client, and new staff member, cracks start surfacing.

The biggest crack comes from the pressure caused by the firm’s staffing philosophy. People are not being added to build a stronger firm; they are being added to support the hunters (partners). In other words, when a hunter hires staff in an EWYK model, the support is all about making the hunter more efficient. For

example, if the hunter is a bow hunter, then staff is hired to carry the bow and arrows so that the hunter can cover more ground due to the lighter load he or she has to carry. Instantly, the hunter becomes more productive. As the capacity of the hunter shrinks again, more support is hired who are continually focused on making the hunter more productive. Maybe the next new hire has the job of guarding and pulling together all of the killed game so that when it is time to skin the bounty, all of the game has been centralized, allowing him or her to be more efficient in the process. Before long, capacity shrinks again and more people need to be brought on board. However, in the end, the hunter continues to do exactly what he or she has always done. He or she still kills the game, skins it, processes the meat, and prepares the food.

Nothing has changed. Although far more people are involved and the operation is much larger, the hunter can't let go of keeping his or her hands in every aspect of the way the operation is run. Clearly, there comes a point in this approach that not only stops an organization from growing, but it becomes a destructive force. This is typically due to the stress this model puts on the hunters, as well as the low satisfaction realized by the staff by simply being assistants to the hunters.

As firms continue to grow and become more successful, their EWYK strategy, which is foundational to the success they have achieved thus far, continues to weaken the operation. This is true because the partners, more and more, are constantly working, but the staff is marginally engaged in the process. Because the partners rely on themselves to be the main point of contact with the client, provide the technical skills to do the work, and deliver the project management skills to complete the project, the staff is marginally developed. Remember, the staff is not being groomed to take over the work, just to be of assistance to the partners.

As cracks become gaping holes, a new model of organization has to be adopted. We call the solution to the EWYK model the "Building a Village (BAV)" or "Operator" model. The BAV model is one in which specialization becomes the key differentiator. We are not referring to the traditional definition of specialization, such as consulting, technology, business valuation, and so on, but, rather, to the specialization that avails itself as firms hire more talent (roles, responsibilities, and a constant narrowing of job duties as more skills become available).

For example, when contrasting the EWYK model to the BAV model, the focus is on hiring talent; narrowing the responsibilities of a job, task, or function; and removing the hunter from processes altogether. So, in the case of skinning the game, someone is hired to perform that function, not guard the game so that the hunter can more efficiently do it later. In the case of processing the meat and cooking it, people are hired to perform those specific duties. You see, it is much easier to hire four different people and teach each one to perform a narrow and specialized task than it is to find hunters who can do it all.

The philosophy of the firm adopting a BAV approach has to shift from trying to reproduce autonomous and multitasked hunters who can do every job to systematically breaking down the jobs of the hunter so that different people can be groomed to perform a narrower aspect of the process.



Chapter 2



Drivers of Change for the CPA Profession

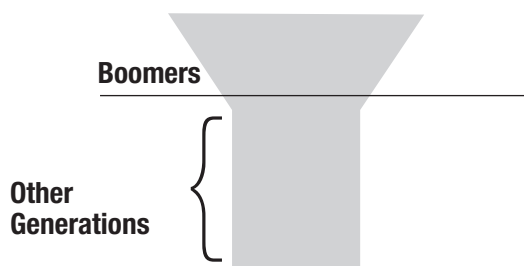
Introduction

To better understand the need for proactive succession planning and management processes, it's a good idea to take a look at some high-level, strategic driving forces affecting the CPA profession. A driving force represents an area that exerts significant strategic influence on a firm. Following are some thoughts on driving forces most influencing the CPA profession, with some implications for CPA firm owners as they think about the future of their firms and their management and succession planning processes.

You might be thinking to yourself, "OK, so this succession management topic is kind of interesting, but why should I focus on this now? I have another five or six years to deal with this. Besides, who has time given all of the work we currently have in-house?" Well, as you review this material about driving forces affecting the CPA profession, those questions and many more will be answered. The short answers to the questions just posed are that time flies, we're working and living in a dynamic environment, and you need to start now because many of the changes you need to make take years to fully implement. It's your professional future and retirement that are at stake. Done properly, succession management can help secure them. Done improperly or ignored, all bets are off.

Although that may sound somewhat harsh, to us, it's simply the facts as we see them. Take a look at demographic drivers. There are hundreds of thousands of baby boomers getting ready to retire, and far fewer members of the next generation are in line to replace them. In fact, in most CPA firms, instead of the traditional hierarchical pyramid regarding staffing that we commonly saw 20 years ago, what we see today is more like a funnel, where too much of the work is being done by the partners and there is not enough capacity to delegate the work down and create the necessary leverage (see figure 2-1). This doesn't bode well for you, especially if you've got plans to retire over the next few years.

Figure 2-1: *Generational Funnel in Firms*



On top of the pressure to find, develop, and nurture people to fix the pyramid, the profession is continuing to deal with pressures caused by increasingly complicated tax laws and a rapidly growing body of standards for accounting and auditing. It's not going to be any easier, and you're not going to have any more time in the future. Today is as good as it gets.

What complicates this more is the "Eat What You Kill (EWYK)," or superstar, model of business under which most firms operate. Senior owners have the biggest books of business, and when they get ready to retire, the firm tends to recruit two new junior partners to replace each senior owner. The reasons are simple. The firm has to replace the actual billed hours, the technical activity, as well as the client management activities that need to be done. A young partner can't be expected to start off managing such a big book or step into such complicated client relationships without first having a great deal of experience in the partner role. This growth model has been working fairly well, but it requires an abundance of interested and qualified candidates.

Given our current professional demographics, not only do we have a shortage of people to consider, but we will likely be forced to live with either replacing a senior partner with only one new junior partner or adding one junior partner every time two senior partners retire (which is the likely scenario). This means that in order to maintain the success and profitability of our firms, we need to abandon the growth model that has served so many firms so well for all these years and adopt one that is far more difficult and complex to make work (the "Building a Village," or "operator" model). We have to rebuild our firms in approximately the next five years in order to better leverage staff, make the partners more interchangeable, and create an operational structure so that fewer partners can manage significantly more business.

In our opinion, clear winners and losers will emerge in our profession over the next decade: the winners will be those who proactively rebuild their firms to be compatible with the demographic changes that are easily predictable, and the losers will be those who believe nothing needs to change because they are above the law of supply and demand.

The following material will give you more insight into how our changing profession will affect the succession road you should consider traveling. We have incorporated thoughts on the following key driving forces:

- Demographics
- Legislative and regulatory
- Technology
- Other marketplace driving forces

We also cover some ideas for dealing with these driving forces in the context of your succession management effort. Once you complete this section, you will be ready to explore any, one, or all of the alternate routes we have developed for your use.

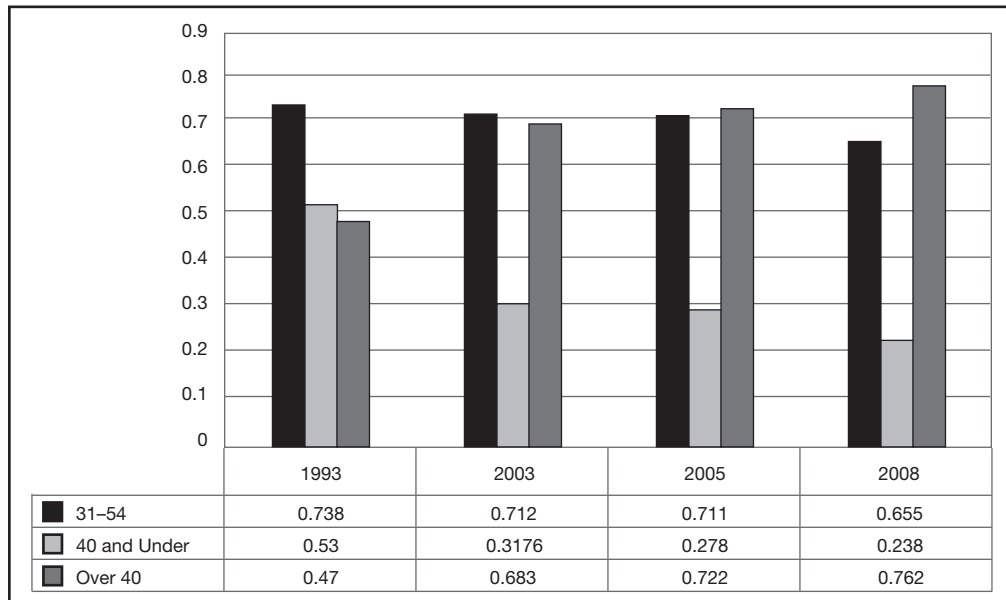
Demographic Driving Forces

Demographers have predicted that between 2002 and 2012 up to 35 million Americans will leave or will have left their occupations. Additionally, they predict that between 2010 and 2030 the overall size of the U.S. workforce will shrink by 10 percent.¹ These two factors alone will put stress on all businesses, including CPA firms. Add to these factors the continued “graying” or aging of the CPA profession, plus the low level of new entrants into the profession, and you have a demographic time bomb waiting to explode.

Presently, baby boomers (born as early as 1946 and as late as 1964) make up the largest segment of the U.S. population. In our rough analysis of membership numbers, approximately 51 percent of AICPA members are baby boomers, but they represent about 54 percent of dues paying AICPA members (see table 2-1). As you can see from table 2-1, the percentage of our members over 40 years of age is growing, and the percentage of those under 40 years of age is declining. Over the next few years, the 25- to 42-year-old age group in the United States should decrease by about 1 million. This group is the core workforce of the country. Everyone will be under more pressure to find quality people for their businesses, and CPAs will be no exception, regardless of how much slack is created temporarily by any negative economic trends that occur from time to time.

¹ Buhler, Patricia M. “Managing in the new millennium: are you addressing the talent shortage.” *Supervision*. November, 2008.

Table 2-1: 2008 AICPA Membership Numbers By Age

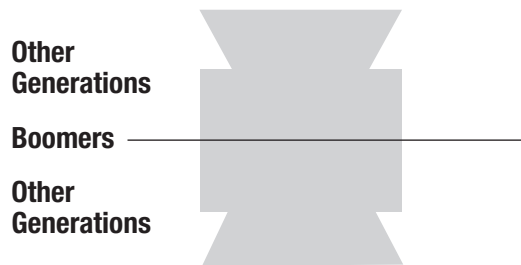


As affluence increases, the birth rate drops. This is true not only in developing countries but also in the United States, Canada, and other developed countries. Presently, the U.S. birth rate just covers the death rate—it's effectively at a break-even point to sustain the total population. The logical conclusion is that, barring immigration changes, CPAs will have a shortage of entry-level people available to their businesses over a long time frame.

Now, let's take a further look at age, gender, and retirement trends and conclude with a few more predictions specifically for CPAs based on this information.

Age Trends

It is clear that our profession is not growing in size but growing in age. When you consider the economic growth over the past 15 years, it is clear that we have not been backfilling with enough young people to balance the growth in workload within our profession. When you look at AICPA member statistics from ages 25 to 65, instead of our profession emulating demand as it has developed and looking like a pyramid (in other words, each year, a few percentage more people would join the profession than were leaving it), we look more like a vase (with the baby boomer generation representing the bulk in the middle), as illustrated in figure 2-2. Although the efforts of the AICPA, the state CPA societies, and the many volunteers have been incredible in motivating young people to enter the accounting profession, that wave has not had enough time or been large enough to either reshape the demographic picture of the profession or balance the workload demands.

Figure 2-2: *The Boomer “Vase” in Firms*

The millennials, or the group of young people dubbed generation Y, have presented some interesting challenges to baby boomers who hire and manage them. It's not uncommon to hear managers in their 40s and 50s lamenting that the young people are difficult to motivate or that they don't have a strong work ethic. The bad news is that younger people in the profession don't necessarily believe that they need to work themselves to death to be successful (as their baby boomer counterparts still believe) but that it is reasonable to expect a work-life balance. The good news is that they are just as capable as any other generation of being motivated to make a difference in your firm and at your clients' places of business. In general, both generation X and generation Y value other factors over money. Many have grown up in affluent conditions and have high expectations for opportunities at work.² They want more time off, some flexibility in work, and the opportunity to learn and improve their portfolio of skills.

Here is the key philosophical issue to understand about generations, at least from our point of view: baby boomers, because there are so many of them, feel as if they have had to scrape for every opportunity. This is not because they have a better work ethic, are more business minded, or represent a higher number of overachievers but, rather, because most of them during their younger, most impressionable years were competing against many other baby boomers for every job opening. Generations younger than baby boomers have grown up in an ever-expanding labor shortage. So, for most of them, competition for each job opening has been minimal to nonexistent. For example, we don't work with a single CPA firm that hasn't in the last decade had an ongoing job posting for an accountant with 5–10 years of experience.

Many of our younger people, because they are members of generations that have grown up with options and an abundance of work opportunities, have had the luxury of demanding more work flexibility and privileges than the baby boomer generation did when they were a similar age. However, the odd part of this story is that all generations, including baby boomers, now work within a profession that is challenged by labor shortages, but baby boomers everywhere are still acting as if they have to fight to keep their jobs. Baby boomers' behavior certainly indicates that, although they are vigilant workers, they don't catch on very quickly. Our working world has changed dramatically in the last 25 years, and CPAs have never been in more demand, yet many of us are still buying into the 60-hour work week as a requirement of our profession. So, the best way we can put this is if the younger

² Wynn, Garrison. "How to deal with motivationally challenged younger workers." Wynn Solutions, 2006.

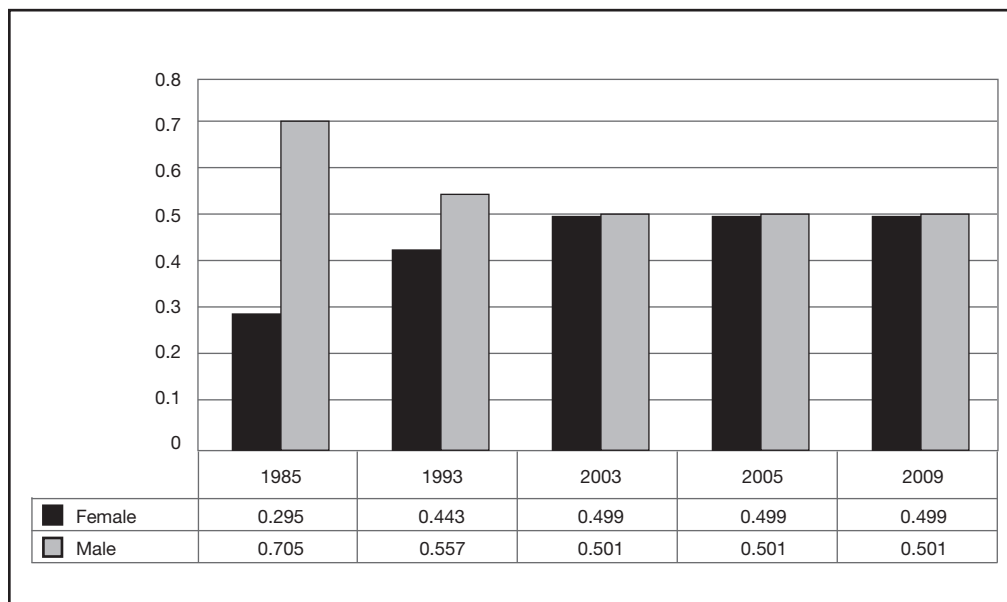
generation is the only group within your firm that is demanding more pay, less hours, and greater job flexibility, this is only because the older group isn't smart enough to demand the same things.

Gender Trends

In the 25–34-year-old age bracket, 14 percent more women than men hold a bachelor's degree, and 21 percent more women hold advanced degrees. Women now make up more than 46 percent of the U.S. labor force, and this percentage will continue to increase.³ In 2005, 72 percent of all women with children were participating in the workforce, compared with only 47 percent in 1975. This trend is expected to continue, as well.⁴

Although the plan (based on a concerted national effort) is for the accounting profession to continue to grow its number of entrants in the coming decade so that we can move from a vase shape to looking more like a pyramid, gender is playing a key role in the evolution of our profession. In 1993, about 45 percent of new entrants were women and 55 percent were men (see table 2-2).

Table 2-2: *Percentage of AICPA Members by Gender*



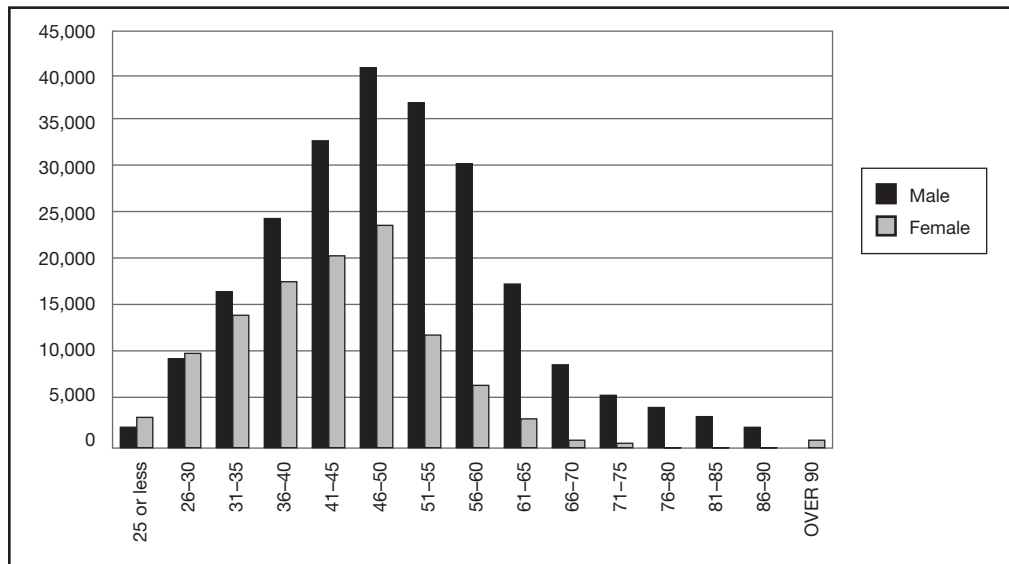
When you look at current membership numbers, it is clear that the trend of women entering the accounting profession has continued to grow and is now reflected in the makeup of the profession. For the first time in our profession's history, among members 30 years of age and younger, more women are working in our profession than men (see table 2-3). The number of female entrants into the profession now equals that of male entrants. Clearly, our profession is becoming more and more appealing to women. Although this is great news,

³ U.S. Department of Labor, Bureau of Labor Statistics. *Occupational Outlook Handbook* (2008-2009 ed.) Washington, DC. U.S. Government Printing Office.

⁴ The Institute for the Future for Intuit. *The Intuit Future of Small Business Series*. SR – 1037A. January, 2007.

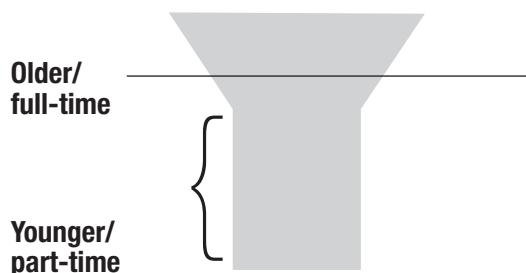
some workload issues are exacerbated because of this shift. Our next paragraph could be construed as bordering on politically incorrect commentary, but we offer it only to point out that in planning for succession, gender is having an affect on CPA firms' ability to sustain and grow their available labor hours.

Table 2-3: *Number of AICPA Members By Gender*



First, let us restate the premise that there has been a work overload because of a staffing shortage. Now, consider that more and more women are entering the profession. Because a perceptible percentage of women CPAs have historically either dropped out of the workforce or moved to a part-time status because of family lifestyle choices later in their career, these choices are reducing the number of labor hours available from a critical pool of experienced CPAs. Although we don't have hard statistics to share with you, we can state with certainty that of all the firms we work with today, every one of them has at least one woman working in a part-time capacity, and most have more than one. However, we only work with one firm that has a male part-timer. The point of this discussion is that firms have to be aware that full-time staff availability and capacity will become more unpredictable because women represent a greater and greater percentage of personnel at CPA firms. This volatility will have a tremendous affect on key manager and partner positions (in available hours to sell, scarcity of experience, shortage of personnel to fill middle management positions, added workload shifted upward to partners, and so on), especially because it takes so long to train successors to fill these higher-level positions.

Given the growing number of people that already are, and will likely become, part-time workers in the next few decades, even though the age demographics of our profession might shift due to all of the excellent recruiting efforts underway in our profession, we are still not out of the woods. Even if our profession started to morph, people-wise, to look more like a pyramid (with expanding capacity at the bottom), the growing number of women in our profession, and the likely continuation of some of these women opting for part-time status, the pyramid shape will likely collapse back to resemble more of a funnel (figure 2-3) with not enough capacity at the middle and bottom layer.

Figure 2-3: *Available Work Hours By Age Due to Gender Influence*

Retirement Trends

On the one hand, many people are putting off retirement (AARP reports that 79 percent of baby boomers plan to work past age 65, some for financial reasons). On the other hand, many, if not most, CPA firm owners who are baby boomers probably have been looking forward to retirement in the years ahead. Yet, some CPA firm owners could be in for an unpleasant financial surprise when it comes time for the retirement they've been anticipating.

Considering the current demographic vase shape (figure 2-2) that looks like it will morph into an upside down pyramid over the next 10–15 years and the number of CPAs in leadership positions who plan to retire during that same period, an almost revolutionary ownership reshuffling is about to take place. This revolution, although significantly driven by demographics, is highly affected by the fact that the CPA profession is very young: most firms still have founding owners working in them. Given this fact, it should be no surprise that many of the founding members of the approximately 40,000 CPA firms in the United States are in the baby boomer generation. When you combine founding owners with the baby boomer generation, it is logical to assume that most firms have not undergone succession from the founding owners to the next generation of leadership.

Taking this a step further, now consider the historical model that has driven CPA firm succession. It works like this: when today's senior partners get ready to retire, firms often bring in at least 1 new partner to fill the void created by the departing partner (rather than spread all of that work and responsibility to the existing partners). These senior partners often are billing workhorses, have the largest books of business, possess tremendous technical knowledge, and know everyone in the business community. Naturally, 1 junior partner would find it difficult to take on such a dramatic load unless a strong support infrastructure was in place. Because strong infrastructure support (trained people with time capacity at every level) is rare to nonexistent in many, if not most, CPA firms, it often takes 2 new partners to replace the retiring senior partner. Given the demographic trends, replacing senior partners at a 2-to-1 ratio can't continue much longer. In 10 years, it will be difficult for firms to replace retiring senior partners at even a 1-to-1 ratio because the size of the group of retiring CPAs will be larger than the younger group that will replace them (the graphic assumes everyone is full-time, which they are not, so the reality is harsher than the statistics represent).

When you consider that CPA firms will be retiring a significant number of senior partners in the coming decade, many of these firms will be transitioning for the first time from their founding owners. CPA firms are continuing to grow, and we will not be able to replace senior partners at a 2-to-1 ratio much longer, so we have a succession crisis in our profession. It is predictable (assuming the reliability of some succession planning survey results we will share with you later in this chapter) that a significant percentage of our soon to be retiring partners are looking to the sale or merger marketplace for their exit strategy. When you consider the leadership challenges, the staffing shortage, and the retiring talent, it stands to reason that we can expect this coming decade to gradually shift to a buyers' marketplace. As the oversupply of sellers expands, the buyers will be in a position to dramatically reduce the purchase or merger price (over what you might expect today); negotiate to buy only parts of a firm (specific clients, a couple of industry niches, and so on); create very favorable deal points; and more.

Some Predictions for CPA Firms

Based on the convergence of these demographics, public accounting will be poised to embrace a great deal of consolidation of firms during this period. Logically, firms with strong leadership and well defined processes and procedures will be well positioned to consume the excess demand from both firms (trying to sell) and clients (looking for a new CPA firm because their CPAs appear lost in transition).

A couple of other trends that are likely to continue or emerge due to this demographic shift are the following:

- Firms will have to become more and more flexible to accommodate the very talented and persistently growing part-time labor pool.
- Owners and managers will need to improve their management, delegation, and supervisory skills to get the most out of their people and prepare their firms for the future they face.
- As the oversupply of CPA firms up for sale is in clear view of our profession, it will become increasingly more difficult to find partners who will want to take on the full burden of buying out their predecessors (especially given the lack of trained talent and infrastructure in place to support them).
- The younger people who are interested in running their own firms will be well positioned to cut very lucrative deals for themselves.
- Right now, approximately 38,500 firms have 10 or fewer professionals. The vast majority are firms with less than \$2 million in revenues. It is in this small firm range where most of the consolidation will occur. In other words, of the approximately 40,000 CPA firms today, we wouldn't be surprised to see that number cut in half 10–15 years from now.
- Expect several hundred new large players to come out of these 15 years of ownership reshuffling, with some small players at \$2–\$5 million growing to more than \$30–\$40 million.

- Even after consolidation is well on its way, serving the various market segments will limit what makes sense in roll-ups. For example, a general direct relationship exists between the size of CPA firms and the size of businesses served. This is to say that a \$1 million CPA firm, compared with a \$10 million CPA firm, has a much better chance of having a cost structure and simplified services that make sense for a \$2 million small business. So, the lifeline of the sole practitioner looks strong, assuming those firms address the many factors required to sustain their practices for future success.

Legislative, Regulatory, and Complexity Driving Forces

In the past 25 years, the CPA profession has continually evolved, from allowing firms to advertise to dealing with the effect of consolidators (which is different than the consolidations we talked about previously), an almost exponential growth in services offered by our professionals, a shift in which more CPAs work in industry than for public firms, an environment in which most states allow non-CPA ownership of CPA firms, moving more and more to a global economy, the explosion of outsourcing, the Government Accountability Office restrictions on independence, the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), and much more.

Our profession is constantly changing. We drive many of those changes internally, from current CPA issues, such as mobility, to international standards, peer review, and so on. The demands of business drive changes, as well; however, the ultimate change driver is the legislative and regulatory machine. When the laws change, regardless of whether you support them, the business environment immediately shifts. Working in this profession really is like riding a series of waves in the ocean, with an even bigger wave building up behind you as you try to ride your current one.

With each bigger wave coming, we seemingly have at least two very different choices. We can try to ride it and take advantage of its power and forward momentum, or if we don't like the direction it is going, we can try to redirect it (or ignore it and hope it passes by without affecting us). For example, talented auditors all over the country knew our audit process had flaws that needed to be addressed. This was a point of discussion at leadership meetings at the national and state levels for years. However, as a profession, we did not take bold enough steps to plug the gaps, and we tried to ignore the coming wave. It wasn't until the marketplace was outraged by Enron and WorldCom that legislation was passed to try to address the needs of the people. Overnight, the audit environment changed.

Interestingly enough, although our members everywhere were concerned about the future of the audit, the legislative changes have actually been a boon for public accounting. Although Sarbanes-Oxley put additional restrictions in place, these restrictions caused firms to raise prices and improve audit quality and profitability. Because of the staffing shortage, the additional effort required to comply with the new standards forced each firm to let go of less strategic audits due to human resource limitations. This created an unprecedented

trickle down service opportunity that has brought additional work to even the smallest firms. It is an example of how regulation instantly and dramatically changed the business environment by adding complexity to the scope of the work. This could have been bad, but fortunately, the unintended or unplanned consequences of this action created a huge upside for our profession. Obviously, you can't count on these dramatic waves of change to bring such a positive outcome.

Surveys conducted by the Private Companies Practice Section (PCPS) over the past 5 years have shown that most PCPS members have serious concerns about their ability to keep up with the changes in accounting and auditing standards, as well as tax laws.⁵ These concerns consistently rate in the top 5 issues identified by firms with up to 20 professionals.

Tax law complexity has grown to such a level that it can be difficult for two CPAs using the same data to come up with the same client tax liability when preparing a sophisticated income tax return. For years, *Money* magazine made great sport of that reality. The fact is that the owners of many smaller CPA firms are struggling to stay abreast of tax law changes and provide appropriate, proactive advice to their clients. At the same time, the growth in accounting and auditing standards has created its own overload on practitioners. CPAs continue to struggle with the interpretation and implementation of accounting and auditing standards. Twenty-five years ago, it was common for an experienced CPA to bounce back and forth between tax and audit engagements. Today, with the complexity in those areas continuously expanding, coupled with our litigious environment, CPAs (as a practical matter) have been specializing in tax, auditing, financial statement preparation, or one of several other common services.

However, a new change that has been building momentum over the past several years is that CPAs are having a harder time pulling off this level of specialization without additional assistance. As an example, it is becoming more common for a CPA professional specializing in taxation to have to call in an expert or two in order to be able to give advice on sophisticated tax issues. Just as we have seen in the medical profession, at some point of complexity overload, a specialization area will break into subspecialties. Fifteen years ago, if someone declared him or herself a tax specialist, that would have been considered a narrow scope of work. Today, we have tax generalists everywhere who rely on specialists in areas such as asset protection, cost segregation, Section 199, estate and gift tax, state and local taxes, international, pensions, and much more to help them determine the tax effect of their clients' transactions or actions.

So, it sounds as if each time we add complexity or standards, the CPA profession wins because more fees are generated and more CPAs need to get involved. Although that is often true, this scenario has a problem. The problem is that it assumes a captive audience and forced compliance. For example, Sarbanes-Oxley applies to public companies. This is now a universal cost of doing business for all U.S. public companies. The playing field is level, and everyone has to comply if they want to be publicly held. When this added complexity finds its way into privately held large businesses, then midsized companies, then down to small

⁵ AICPA. "Weathering the Storm: What the 2009 PCPS CPA Firm Top Issues Survey Says about the Economy's Impact on CPA Firms." AICPA. New York, 2009.

businesses (to which it is just starting to trickle down), an entirely different reaction can be anticipated. Because these businesses are not controlled by Wall Street and because smaller businesses' key financial partners are most likely owners, banks, or private venture capitalists, other less costly alternatives will likely be sought. Why? Because it is not in the best interest of the financial backers of these entities to dilute the profits of their investments with unnecessary, expensive compliance work that does not better protect them (these financiers usually have their own internal systems to monitor the value of their recoverable assets).

Already, at least in some smaller markets, CPA firms have encountered pushback to the necessarily higher fees required to perform attestation work resulting from the more rigorous audit standards. Some firms have used this as an opportunity to reduce the scope of work from an audit to a review, in order to pacify the fee resistance. Unfortunately, for those clients who still want the audit but are unwilling to accept the higher fees, many firms are defaulting to their age-old strategy of reducing prices to keep the client happy. They are trying to fit a square peg into a round hole. Given CPA firms' staffing shortages, discounted pricing, and increased work requirements, the owners will either make little to no money on these services or cut corners on the work they should be doing. Fitting the square peg into the round hole will likely end badly for the owners and the firms if their strategy doesn't change soon.

Here is a case in which the current legislative environment, although it has created a great deal of opportunity, also has generated price resistance in certain market segments and will likely spawn alternatives. Although no non-CPA audit replacement service has gained substantial ground, several years ago we saw a few banks offer for-fee asset monitoring services in lieu of audit requirements. A boiling point will be reached when fee pressure will potentially create enough market uproar that even a service held in high esteem, such as audit, may be replaced out of nowhere by a non-CPA type of service that is considered more reasonably priced and relevant to the needs of the audience.

Technology Driving Forces

No discussion of driving forces affecting the CPA profession would be complete without including some coverage of technology's present and potential future effects on CPA firms:

1. Internet availability has changed the way just about everyone does business. In even the most remote areas, it's possible to have some kind of access to the Internet. This means that clients are able to become increasingly more sophisticated consumers of professional services. Due to the Internet, they can more easily access a variety of information and articles, as well as participate in forums and conversations online with others from their industry. They have more access to free information on technical matters for which they once had to rely solely on CPAs, and they have instant access to offerings, information, and services from your competitors.
2. Web-based accounting and tax applications are becoming more ubiquitous, allowing small businesses to maintain their books and records through application service providers without having to install software on their computers. Many individuals who

used to rely on CPAs for tax and financial statement preparation have taken more of that work on themselves. With proper coaching and assistance, clients are able to be more self-sufficient with respect to these services. As these financial technologies gain sophistication in their ability to decipher the tax or accounting effect of client transactions, they will continue to drive the price of these services down and potentially eliminate the need to involve a CPA altogether.

3. Many CPA firms have gone or are in the process of going paperless by converting from the traditional hard copy paper files to electronic working papers and files. This allows CPA firms to more easily share files within the firm, allow part-time or telecommuting employees to easily access firm files working at home, have employees all over the country rather than be limited by the local geographic area, and utilize out of country outsourcing to augment staff shortages. These technologies facilitate clients preparing their year-end working papers in an electronic form and allow them to easily transmit or share their working papers with their local CPA firm and, at some point in the possibly near future, their new chartered accountants in India or China.

Consider the AICPA vision statement.⁶ Technology was a driver for the new direction that was chosen. Look at the information value chain, which can be summarized in figure 2-4. First, business events create raw data. That data must then be organized into information for it to be useful. Information has be analyzed, synthesized, and managed so that it can be transformed into knowledge. Knowledge is the foundation of good decision making.

Figure 2-4: *Information Value Chain*



CPAs have been in the data gathering and presentation business for a long time, and we do it well. Financial reports and tax returns are good examples of taking raw data and converting it into information. However, technology continues to erode the necessity of CPA services to support this conversion, especially in less complex situations. This creates a challenge for our professionals to push their competencies and services beyond information analysis to help organizations harness knowledge. This means that we need to not only better communicate what we know but take information to its next higher level by transforming it into knowledge. At this point, we are primed to help those we serve by, as the AICPA vision statement says, “anticipating and creating opportunities and designing pathways that transform vision into reality.” This is one of the actual vision statements that focuses our efforts on assisting our clients to access the applicable knowledge that will help them in their decision making process.

⁶ www.cpvision.org

To support this concept with financial data, a survey done more than a decade ago by Kennedy Information, Inc. looked into these areas. The rates for services back then were about 450 percent higher for those assisting clients in the knowledge and decision-making space versus those working in the data-to-information space. As professionals who work in the “What are our options and what should we do?” area, we can attest to the fact that the price gap is even higher today. Couple the fact that the marketplace pays much more for assistance in the knowledge and decision-making space with the reality that technology is performing some of the data-to-information conversion for us, and it is clear that technology is affecting the kinds of services our profession is and will be delivering.

Marketplace Driving Forces

In addition to demographic, legislative, and technology drivers, the following other trends in the CPA firm business environment are having or will have a noteworthy affect on the size of the marketplace waves we either are or will be encountering:

1. The creation rate of personal businesses (one person businesses with no employees but the owner that are often operated from home) is on the rise, and the number of these new businesses will continue to increase. This is the result of other trends and circumstances. For one thing, downsizing, reductions in force, and so on have made this a more viable and necessary option for some workers. Also, many baby boomers have been and will be starting these businesses as they leave corporate America and become “actively retired” in a new business venture. The number of businesses created by people in the 55- to 64-year old age group is 28 percent higher than the adult average in the United States.⁷ This could mean a new source of business for many smaller CPA firms.
2. The legislative environment has created a market surge anomaly because it is requiring many organizations to hire multiple professional firms to perform the services traditionally done by one firm. In addition, due to staffing shortages and increased compliance standards, firms are shedding their less strategic clients and creating new business opportunities for the next CPA firm. Both of these current market conditions are creating additional opportunity across all sizes of CPA firms. Although we have predicted in past articles and publications that the marketplace will tighten up as soon as this musical chair game has run its course, we have good news. For those visionary CPA firms that are planning and staffing for succession, the next big wave of unencumbered clients will come from those firms who haven’t. Although retaining quality, trained, and experienced staff will remain a critical success factor throughout the next decade, we see an available stream of new clients for the taking for years to come. However, profitability and success will become more dependent on a firm’s ability to determine and commit to engaging a target client profile. It will be important to set up systems and compensation so that partners are not motivated to take on just any client but to find the right clients. This also means that once you

⁷ The Institute for the Future for Intuit. *The Intuit Future of Small Business Series*. SR – 1037A. January, 2007.

have culled your client base so that it looks similar to your client profile, it becomes imperative to create a culture that

- a. develops and maintains client loyalty.
 - b. ensures the needs of your clients are being satisfied (rather than just selling them the services you offer).
 - c. builds a wall of services around them, which for smaller firms will likely incorporate a strategic alliance of several CPA firms, to protect them from poaching from other CPA firms.
3. Because of the legislative environment and the increased focus on independence, during the next decade, many firms will drastically reshape the services they offer. Some firms will surround all of their offerings with a cloak of independence, but others will move to the opposite side of the spectrum (management advocates), with room along the continuum for everyone in between. Those firms that rethink the synergy of their services and develop their service strategy early will be able to
 - a. quickly create alliances with other firms to minimize service gaps in their offerings.
 - b. attract clients from firms that discontinue services that the clients need.
 - c. create a culture that understands that the greater the number of different services a client purchases from your firm, the greater their loyalty to your firm.
4. Consider the typical situation in a small firm in which an owner oversees the performance of one audit or review in a particular industry (for example, one construction contractor or one car dealer). In this example, besides this one engagement, the firm does no other work for members of this particular industry. This situation is rampant in CPA firms across the country. We believe the owner(s) really need to rethink the advisability of continuing with these kinds of one-off engagements. Given the level of diligence required to perform the service, the complexity of our standards, and the need to truly understand the nature of the client's industry, how can the firm perform this work by doing only one engagement a year? How much risk is the firm willing to take cutting corners to maintain profitability? How much profitability is the firm willing to burn in order to maintain the expertise needed to deliver on low-volume projects? What it comes down to is, as legislative forces change and the marketplace shifts, CPA firms need to scrutinize their strategy regarding the clients they will continue to serve and the services they continue to perform.
5. The succession issue CPA firms are facing is demographic, which means it permeates every type and size of business. It makes sense that many small businesses will sell, merge or consolidate, or go out of business trying to find their next leader. For every merger, this means that one less entity will require accounting and tax services, and the surviving or acquiring entity will likely shift most of the local work to its corporate CPA firm. When you factor in that fewer than one-third of family businesses make it to the third generation and less than one-half of those make it through that generation to the fourth generation, even CPA firms that build very loyal client relationships may find themselves needing to replace key clients due to ownership transitions.

Don't assume that, just because the family business successfully changes hands within the family or current management, your CPA firm will maintain its current relationships. Often, regime changes in family businesses result in the new management changing advisors. CPA firms that thrive in the future will have created and sustained a culture that

- a. carefully builds and maintains relationships with multiple generations of managers at a client's business.
 - b. always knows what business concerns the client firm needs to address and finds a way to help address those concerns either through services they offer or their professional network.
 - c. encourages, trains, and rewards people for teamwork resulting in high levels of client satisfaction.
 - d. capitalizes on client and referral relationships to continually feed quality new clients into the firm's pipeline.
 - e. continually hires and trains people to provide the capacity to profitably take on new clients.
6. Many firms are acting like they are selling declining-demanded services within a dying industry (that is, they don't want to invest any more than necessary so they can take as much cash as possible out each year). This strategy is commonly referred to as *milking the cash cow*, and it is going to hurt many small to mid-sized firm owners in the coming decade.

In these situations, the owners are basically withdrawing all of the current earnings, rather than investing in the future of the firm. The senior owners are letting this deferred maintenance on their firm build up and become an unstated liability to be assumed by the junior owners in the future. In doing so, they are putting their firms and their potential retirement payouts at great risk. For firms to be successful in the future or increase their value today, they should be currently making commitments to

- a. build a well-run business.
- b. establish an infrastructure that has time capacity so that as owners retire people are available who can take over the work.
- c. develop a diversity of skills.
- d. attract and retain highly trained people.
- e. be technologically well equipped and savvy.

Forces Summary

The forces we have discussed in this section (demographic; legislative, regulatory, and complexity; technology; and market) are drivers that we have to contend with all the time. Make sure you are spending an appropriate amount of time trying to figure out how to ride the building wave, rather than ways to fight it. If you spend enough time planning, you will find ways to leverage these forces in your favor.

Succession Management Survey Results

In January 2008, we conducted a succession management survey for the PCPS.⁸ Approximately 500 public practitioners responded, of which about 125 worked in single owner firms and the remainder worked in multiowner firms. Annual revenue ranged from \$44,000 at the low end to \$120 million at the high end.

Because of this diversity, we segmented the responses into two different reports: sole proprietor firms and multiowner firms. When applicable, we also compared the results of this year's survey with the 2004 PCPS survey on succession. We have provided the two succession reports as appendix 1, "PCPS 2008 Succession Survey Results: Sole Proprietor Firms" and appendix 2, "PCPS 2008 Succession Survey Results: Multi-Owner Firms," based on the questions found in appendix 3, "PCPS Survey Questions," all found in the back of this book. Whether your firm is a single owner or multiowner firm, you should find both reports of interest. In addition to the two reports, we are providing the survey questions as a separate attachment because many firms have found the survey questions valuable in helping them think through various succession issues.

⁸ AICPA. *2008 PCPS Succession Survey*. The Succession Institute, 2008.



Chapter 3



Positioning Your Firm for Succession and Retirement

Introduction

To position your firm for succession or change, the first thing you need to do is clean up the operations. Firms mostly are inert, which is a simple way of saying, “We just keep doing what we have always done, with an occasional effort to do what we have always done a little faster.” Cleaning up your operations means far more than just creating a positive bottom line after market-based owner compensation. It means that you have systems, processes, and policies in place to allow the firm to function effectively and efficiently, regardless of who is in the driver’s seat.

You need to deliberately develop consistent methods of dealing with staffing, service delivery, marketing, and growth. It means that you create an operating culture that is formalized so that everyone knows what is expected, what is outside of their authority, and what is within their powers. This culture should be created with such clarity that everyone is empowered to be a watchdog, protecting the core values of the organization. This is the kind of organization that can stand the test of time and leadership change because new bad management practices, which will constantly emerge, are attacked by the firm’s personnel like antibiotics assaulting bacteria—the bacteria is neutralized before any real damage is done.

We have identified several options that firms typically consider in their succession planning and we want to provide you with some insight into these options, listed below.

- Selling your practice
- Merging your practice into another practice
- Buying or merging practices into yours
- Operating your firm in a way that allows leadership changes to be as seamless as possible
- Turning the lights out when you leave

For all of these options, we have some nuances, tips, and insights about how to maximize the positive and minimize the negative outcomes.

In this chapter, we're going to address those fundamental steps that will benefit you, regardless of the alternative you choose. The ideas covered here are integral to each of the succession strategies previously listed. So, rather than repeat this information under each succession alternative, we have arranged the material in this book so you can review the elements common to all strategies and then shift your focus to the nuances of the approach that is of interest to you.

In this chapter, we will walk you through a quick summary of areas you will want to address before you strike a deal for a sale, acquisition, merger, or internal buyout. You wouldn't put your house on the market without doing a little painting and fixing up, and you shouldn't put your firm into play before you've had an opportunity to put the best face on it, as well.

As you read through this material, you'll see some tips on a list of key performance metrics that can help owners better manage their firms. We recognize that some firms monitor substantially more performance measures than we've listed, and that's fine. All we're saying is that the metrics here represent a starting point for some good discussion and perhaps an opportunity to take a fresh look at how you're running your business.

In addition to performance metrics, you'll see summaries of several strategies for improvement that can help you develop a more robust succession plan and assure you of a positive outcome for your succession management efforts. These strategies cover the following areas:

- Overall firm strategy, vision, and values
- Business model
- Management and governance
- Standardized procedures dealing with areas such as the following:
 - People management
 - Marketing
 - Client acceptance and retention
- Improving the bottom line and more

Overall firm strategy, vision, and values are important because they drive the rest of your business decisions. You can't build a viable succession plan without tying them all together. The strategy process defines who you are as a firm, where you're headed, how you're going to get there, and what compromises you're willing to make. Without a plan,

everything looks like an opportunity, and if you pursue every opportunity, you won't have the resources to carry out the critical improvements in a cohesive way. Without a strategy, it also is difficult to properly evaluate any merger or sale opportunities that might come along as you work on your succession management processes. What's more, your strategy should drive the business model you choose, the management and governance approach that is best for you, and the processes you need to implement. Recognize that a foundation principle of preparing your firm for succession is having it operate in a way that leadership changes have a minimal effect on daily operations. Additionally, the value of a firm is significantly affected by how quickly its people and processes can be integrated with those of another firm.

If your firm is like some of the firms we see, you would benefit from standardizing more of your procedures. For example, your staff shouldn't have to learn a different process to follow depending on which partner for whom they work. The more standardized your firm, the easier it is to develop competent staff quickly, hold people accountable, change leadership, and change owners.

Finally, we talk about some other, basic steps you can consider to help boost your bottom line. The more net income your firm generates, the greater the value of the firm to the owners and others.

Take whatever time you need to review this chapter, as well as notes regarding areas you want to put on your improvement "to-do" list. Once you're done, you'll be ready to get into some specifics about the succession alternative of your choice.

Cleaning Up Operations—Information Systems and Performance Metrics

The first step in this process is what we call objective reengineering (we will get to subjective reengineering a little later in this section). Although this may seem obvious to everyone, you need to have a database of practice statistics to help you monitor your relative success. For those buying, selling, or merging (regardless of direction, up or down), those same statistics will help you prove your case about the value or pooling interest you feel you deserve.

We find that a surprising number of owners regularly review their firm statistics and many even compare them to best practice benchmarks, but the exercise is often one of justification or rationalization rather than trying to figure out how to build a better, faster, stronger organization. Because these owners don't pay much attention or give much weight to these statistics to guide their process improvement efforts, they are likely

- to utilize sloppy reporting systems for pulling this information together.
- receiving the data after it's too late and too old to be most useful.
- not tracking the operating metrics as comprehensively as they should.

We are no different than our clients, although we always make exceptions for ourselves. We should be running our firms more by the numbers (which are tied to our strategy), just as we advise our clients to do.

Performance Metrics

So what are some of the metrics you should be regularly monitoring to help you better manage your firm and position it for succession? The following are a few key metrics that can help you. The good news is these same statistics are valuable to anyone who is interested in getting a thumbnail sketch of what's going on at your practice. You can track many more metrics, but for our purposes right now, we'd like to start with those found in table 3-1.

Table 3-1: *Standard Performance Metrics*

Total Hours Worked	Total of chargeable and nonchargeable time by person, staff level, department, or other insightful grouping of staff and partners.
Total Chargeable Hours	Chargeable hours by person, staff level, department, or other insightful grouping of staff and partners.
Total Nonchargeable Hours	Nonchargeable hours by person, staff level, department, or other insightful grouping of staff and partners.
Gross Production	Amount of total charges generated in the firm (chargeable hours times hourly billing rates) by person, staff level, department, or other insightful grouping.
Net Revenues	This is your "billings." Amount actually billed after adjustments for write-ups and write-downs by person, staff level, department, or other insightful grouping of staff and partners.
Realization Percentage	This is net revenues or gross production. This should be by person, staff level, department, or other insightful grouping of staff and partners.
Full-Time Equivalents	This is the total number of full-time people in your firm, such as partners, directors, managers, seniors, staff, and administration. Full-time people are easy because each person represents one full-time equivalent. For part-timers, you add their time together and make an evaluation. For example, two half-time personnel would be one full-time equivalent.
Net Revenues by Department or Service Group	Net revenues broken down by department or service grouping (Audit, Tax, Advisory, Wealth Management, and so on).
Net Revenues per Full-Time Equivalent	This is the simple calculation of net revenues divided by full-time equivalents
Net Revenues per Owner (Average Book Size)	This is net revenues divided by the number of owners (often called <i>owner book</i> or <i>owner run</i>).
Payroll to Net Revenues	This is payroll (excluding owners' pay) divided by net revenues. For some firms, depending on the ownership and compensation model, this also might include all guaranteed owners' salaries.
Leverage	Book managed by owner divided by all owners' personal billings on that book.
Net Book Revenues	Book managed by owner less all compensation paid to that owner.
Multiplier	Net revenues per person divided by their salary.
Growth in Net Revenues	This should be calculated both in absolute dollars and as a percentage of the prior period net revenues. In addition, budgets and plans should reference expected growth in net revenues.
Net Profits	Net profits are net revenues less all expenses, excluding owner compensation. The only owner compensation that typically would be included as an expense would be for monies paid to nonequity owners.

Table 3-1: *Standard Performance Metrics (continued)*

Net Profit Percentage	Net profits as a percentage of net revenues.
Average Owner Compensation	Net profits divided by the number of owners.
Staff Turnover	For professional staff, the gross number of departures from the firm for any year.
Staff Additions	For professional staff, the gross number of new hires for the firm for any year.
Days' Revenues in Work in Process	Work in process / (Net revenues / 365)
Days' Revenues in Receivables	Accounts receivable / (Net revenues / 365)
Marketing to Net Revenues	Marketing costs (all marketing materials, sales materials, advertising programs, consultant time, and personnel solely supporting the marketing function) divided by net revenues.
Technology to Net Revenues	Technology costs (all expenditures for software, hardware, upgrades, repairs and maintenance, training conversion costs, and personnel solely supporting technology) divided by net revenues.
Training (Continuing Professional Education) to Net Revenues	Continuing professional education costs (all out-of-pocket costs associated with continuing professional education for the firm and staff solely supporting the training function) divided by net revenues.

With respect to the measures noted in table 3-1, you probably are saying to yourself, “We already track that here,” or “Why do we need to track that one?” Although you can track, and probably should track, other performance measures, the preceding list will help you zero in on some low hanging fruit for operational performance improvements. Incidentally, you also must address other compelling issues as you position your firm for succession, retirement, and general economic success. These matters (for example, dealing with strategy and specific aspects of operations and governance) are covered later in this chapter, after we walk through the metrics.

Note that you should consider two or maybe three benchmarks when managing the metrics. The first is “Actual Performance to Budgeted Performance.” The second is a trend line: “Actual Performance Compared With the Last Three Years.” The third is benchmark comparisons to other firms but only if you have access to them, trust the source, know that the firms are reasonably comparable to yours, and you are confident that the numbers are being generated using a consistent set of rules. Notice that we list using benchmark statistics last because managing your business is about connecting the dots between your strategy, your improvement efforts, and your progress against your plan or the past. These comparisons are far more important than just comparing your numbers to those from organizations you don’t know.

A key to using firm benchmarks is that you not only need to know the firms you are comparing but you need to be able to ask questions about how those results are accomplished, such as: who, what, where, when and how “Firm A” has a 4% Technology/Revenues percentage and the average is 2%. This would imply that firm A is making a bigger commitment to technology than the average. However, firm A could just be a laggard in this area because, for example, the average firm made its commitment to go paperless two years ago, and its technology expenses are down this year because it is embroiled in the

people processes of implementation. Another reason could be that firm A included its technology consulting company fees and direct technology training costs in its numerator, but the other firm only included the technology hard costs, such as hardware and software. The point is that putting a lot of stock in a comparison when you can't find out the reasons for it doesn't have nearly as much value as managing to your strategy and trend line.

With this in mind, we are going to break reviewing these metrics into two sections. The first is to look at each one and give you a little insight about why each is important and what to look for. Then, we are going to give you our shorthand version of how we quickly assess a company and what we glean from these statistics.

Comments on Each Metric

Total Hours Worked

This is a helpful number to have, broken down by staff level. Owners' total hours versus managers' total hours versus other professional staff total hours will provide you insight about which group is "pulling the wagon" (working the hardest) and how much capacity you have. Obviously, capacity is a key component to understand when mapping out your growth strategy.

What's an appropriate range for total hours worked? It depends on short-term and long-term circumstances and firm objectives. For decades, our profession has stated to employees that they work for a 50-hour-per-week employer, with many weeks during tax season extending to 60 hours or more. Historically, many firms have had significant variances in their business cycles, with tax season being crunch time followed by a much more laid-back, slower time period. Today, although many firms still have an intense tax season, it is backed up by three more quarters of intense work, as well. A final common variation that affects the appropriate range of work hours is situational. People will rally around a firm's short-term situation and do whatever it takes to complete several unusual large projects or dig in to overcome being short-staffed as a show of support for the firm.

However, firms have taken these techniques to the maximum, still keep pushing, and then wonder why there is fallout. For example, if a firm has been short-staffed for five years, this can no longer be sold as a short-term problem and will be widely recognized as a management commitment problem. Another example is that the seasonality is virtually gone from the firm's workload, and every month is crunch time. Back when staff labor was in greater supply (or if you are one of the largest firms where people plan to work for a couple of years just to get the brand name and leave), it was easier to get away with this "gut it up and crank it out" approach. However, today, in order to attract and retain staff, more and more firms are selling themselves as work-life balance organizations with more flexibility regarding overtime. In addition, a growing number of firms are starting to do away with overtime requirements altogether. If you are running a CPA firm that is doing well but your profitability and success are based on everyone working excessive hours, then you are swimming upstream if you think this will be easy to maintain. If this is your approach, make sure you are paying your people a lot of money (top of the market) or you may soon find yourself losing your top people to competitors because the market is currently paying top wages for 40-hour work weeks. Even if you and some of your people are nuts about public

accounting and this is what everyone wants to do all day and night long, recognize that this approach always burns people out. So, make sure you properly manage your total work hours for the sake of the long-term health of your people and organization.

Total Chargeable and Nonchargeable Hours

Again, broken down by staff level of employee, this number will be used in other calculations and, when compared to total hours, indicates how much your people are being utilized. Comparing the chargeable and nonchargeable hours of partners to managers and other professional staff will provide some interesting insights, as well. Do your owners or managers, or both, have as much chargeable time as your staff? If so, this normally means that you're not pushing tasks down to the lowest possible level, and you're not developing your staff as fully as you should. To this comment, some CPA firm owners might respond, "Yes, but we don't have the time to train the staff in some of this work because of its complexity and their lack of experience." However, this is one of the most common traps that catch CPA firms. If you persist in this type of thinking and action, your staff will never have the experience they need to do the more complex work, and you will still be doing work you shouldn't be doing. The best news of all is that you will likely find yourself having to work even more hours to find new staff to replace those people who left to work for organizations that are committed to taking the time to develop them.

So, what's a good number here? Again, it depends. We typically see the following real ranges of chargeability within CPA firms:

Partner	1,000–1,200
Manager	1,300–1,500
Senior	1,400–1,600
Staff	1,500–1,700
Bookkeeping	1,600–1,800

What if your total, firm-wide charge hours are not as high as they should be? The reasons are usually simple and one of the following: poor training, improper delegation, poor training, improper delegation, poor training or improper delegation. (Hopefully we are making ourselves clear here.) Each higher-level worker should have an obligation to constantly pass work down and train. With each higher level, as nonchargeable hours increase, although the training hours are still the same, other activities (such as client management and internal firm management) consume the unencumbered time.

On the other hand, we often find situations in which people are not charging for all of the time they spend on clients' work. This may be true because some people make an assessment at that moment about whether time will be billable. If this is the case, set a policy to record it all, with the freedom to make that judgment when an entire picture can be seen. For example, everyone may agree that a 10-minute phone call should not be billed. However, what if the client made 20 10-minute phone calls asking for help during that month? Let's make sure we are making that decision with all of the information available by recording all charge time.

Another common reason people don't record all of the time they spend on client work is because of punitive management practices. For example, if you have recently browbeaten

someone about not making budget on their jobs, don't be surprised if he or she starts to "eat" some of his or her time to avoid this kind of interaction with you in the future. What makes this really unfair is that many owners browbeat their staff for the owners' failings, such as setting budgets that were unattainable in the first place due to the owners' giving away the work by proposing unrealistic fees or succumbing to clients' unreasonable demands or expectations.

If people are writing their time down and the owners are selling the service at a reasonable price, then constantly coming in over budget could be as simple as work inefficiency. This can be the case when the firm has not developed concentrations or specialties that allow people to really get good at what they're doing. If your firm has a lot of one-off engagements or won't allow personnel to pick a specialty area on which to concentrate (audit, tax, and so on), it's probable that the learning curve or start-up time between jobs is out of line. Similarly, if the people doing the work haven't been properly trained, they could be spinning their wheels or performing unnecessary procedures that drive up the time without adding value. In any event, systemic approaches can help you begin to fix this problem.

Gross Production, Net Revenues, and Realization Percentage

Obviously, gross production is important, and it's particularly important when you look at it compared to net revenues. Net revenues represent gross production net of write-downs and write-ups, and the comparison of the two creates realization percentage. A large gap between gross production and net revenues (large write-downs) could be the result of one or two higher-level causes: (1) the firm simply isn't billing enough for the work it performs, or (2) the firm is experiencing unusual inefficiencies due to inadequate supervision and training of its people or its pursuit of one-off engagements.

Net Revenues by Department or Service Group, Net Revenues per Full-Time Employee, Net Revenues per Owner (Average Book Size), and Payroll to Net Revenues

Net revenues by department or service group is very straightforward. The real focus of this number is for trend line analysis, as well as percentage of total revenues to mark shifts in workload. Net revenues per full-time equivalent (FTE) is a key indicator of the relative financial condition of your firm. Generally, the higher the net revenues per FTE, the more attractive your firm will be to both insiders wishing to buy into ownership and outsiders looking at the firm. A high revenue per FTE is certainly no panacea because this number also can be very misleading. For example, this ratio can be very high because the partners work all the time and their personal billings make up a significant portion of the firm's income or because the firm operates in a very affluent marketplace (which means that although it is most likely charging a great deal for the time, it also is likely to be paying a great deal to the people who are doing the work). In both of these cases, although this ratio would lead you to believe that the firm has a very profitable operation, that is really not the case.

One of the key things to understand about using performance metrics is that they are meant to help uncover important questions to ask, not be the answer in themselves. In day-to-day management, as you focus on improving one metric, you may find that a

counterbalancing metric deteriorates, resulting in a negative outcome. In some cases, you may improve several metrics without realizing the rewards you anticipated, so your focus may need to shift to uncovering or creating new measures that will more readily help you monitor the changes you are trying to manage. For example, you might focus your attention on improving realization and find that your firm moves from an overall 76 percent to 85 percent. Clearly, this is a significant improvement. However, if the cause of this improvement was due to a drop in recorded chargeable time because people started shifting more chargeable time to nonchargeable time or working more hours and not recording them, then you have just traded one problem for another (which, over the long-term, might have a greater negative impact). So, the key is to constantly refine the metrics you manage to give you the balance you are looking for.

Now that we have covered how this metric can be misleading, let's focus on its positive side. So, what's a good range for this number? The first answer is trending upward from your previous years' results. When we see a firm under \$100,000 per FTE, these firms are usually throwing away some serious income that should have gone to the owners. When revenue per FTE is that low, it is common for the partners to not be making much more than some of the senior employees. This creates a bad operating model because these firms will find it harder and harder to attract new owners because there is clearly, as we would say in Colorado, "no gold in them thar hills." If you want people to want to become owners and take on the additional risk and headaches, a pot of gold needs to be in clear sight. So, you want a distinctive, meaningful gap between any owner and all nonowners, or you will be motivating people to remain employees or, worse, move on to other firms who have figured this out.

On the other side, when you examine the results of various Private Companies Practice Section (PCPS) surveys, such as the annual MAP survey, you will find some firms operating in excess of \$400,000 per person. Clearly, if you have one owner (solo practitioner) who operates in a specialty area, this kind of number is easier to achieve, but when firms of 25 people and more are doing this, you know they are doing some creative things to leverage their earnings.

We typically find that when firms outside of the large market areas (because of the skewing that occurs due to much higher-than-average billing rates for all employees) are able to generate approximately \$130,000–\$200,000 per FTE annually, they have plenty of profit to build a sustainable operating model.

Net revenues per owner is just a quick indication of the size of book, generally speaking, that the owners manage. The specific breakdown per owner is often referred to as *owner book*, *owner run*, or *managed revenues* which is simply a list by owner, with each client assigned to that owner and total fees billed during that period. The larger the firm, the more you'll see principals, directors, and managers carrying books of business, too. So, once again, this is just an indicator. However, if a firm has \$3 million in revenues and 6 partners, that tells you that the average partner manages \$500,000 worth of business. As we will discuss in more detail later, this average book size indicates a number of likely problems the business will encounter, which will be exacerbated as partners retire.

The final ratio we listed in this grouping was payroll to net revenues. This is just a handy cost-of-goods-sold number. As we stated in the definition, this number can exclude all owner compensation, or it might include the guaranteed salaries of owners. It is for your internal use to track your inventory (your people) cost relative to revenues (the impact it is having on your profit margin). Often, when guaranteed salaries are included, it is because a couple of partners have so little equity in the firm. When the compensation system is really directed to the heavy-equity players (and junior partners are making just a little more money than they did as senior managers), adding those owner income guarantees to the numerator is more reflective of the firm's cost-of-goods performance. If you wanted, it would make sense to include employee benefit costs, as well. Metrics are for you to use as you see fit because they help you make better management decisions. However, as you can see, because they are so easily customized, many of these ratios are difficult to use in comparison with other firms.

Leverage and Net Book Revenues

Leverage is a quick ratio to determine whether owners are utilizing staff in the work they manage. This is why the numerator includes all owner chargeable time divided by the book they manage. This is not meant to be an exact science because we don't verify that all of an owner's time is charged against their own book. We made this up to get a quick feel of how much nonowner time, compared with owner time, is being charged. For example, if an owner has an \$800,000 book and his or her personal billings are \$300,000 and no other owners billed time against that client work, the leverage ratio would be 2.66. However, if another owner billed \$100,000 of time against that book, then the ratio would be 2 ($\$300,000 + \$100,000 = \$400,000 / \$800,000$). It takes zero management or development skill for an owner to turn a project over to another owner. Firm-wide leverage is created by breaking projects down, involving managers and staff, and training and coaching them through the work. This is what creates leverage in a firm. Yes, you can develop this into a much more sophisticated metric by obtaining runs of all owners' time by client and then rolling up from there. This extra effort would be important if a number of the owners served in support roles to those owners managing client relationships.

Net book revenues is a simple number that shows the margin available to the firm after the owner is compensated. If an owner has a \$350,000 book and that owner takes home \$300,000, then total revenues available to pay support staff, overhead, and so on are only \$50,000. Remember, each of these metrics tells a simple story; however, none of them tell the full story. On one hand, if the owner of the previous book doesn't support a number of other partners, then that owner really doesn't contribute much to the firm's long-term success. As you can see, he or she probably takes out more than he or she contributes. As the firm grows, he or she likely will continue to manage his or her small book, and the success of the firm rests on the backs of the other owners. We have seen cases in which an owner, because of the success of the firm (not that owner's personal efforts), manages a book of business and takes home more than he or she grosses in revenues. Not only are these owners not contributing to the overhead and working capital of the firm, but they are taking working capital away because of their minimal contribution.

On the other hand, if the owner in the previous example does a great deal of work on other owners' clients, then it might be one of the other owners who is not pulling his or her weight rather than this one. As previously stated, performance metrics help identify where you should be asking questions in your practice.

Multiplier

This is another measure we devised to see what kind of contribution each employee is making to the firm. It compares the net revenues of each employee to the compensation you pay them to generate that revenue. Besides using the metric on a person-by-person basis, it also can be used to look at staff levels of employees. This ratio can be especially telling for part-time workers because too many of them are tied up in too many hours of nonchargeable duties. Although you might have a situation in which both full and part-time workers at the staff level put in about the same number of nonchargeable hours, the part-time workers' profitability tanks because their work hours are so limited.

What should this ratio be? That is a good question. We conducted research on this with a group of our clients several years ago, and the range of firms included some exceptionally profitable ones, as well as firms with average profitability. In our work with firms since performing that original analysis, these metrics have proven to be a good starting place for analysis. Once again, these metrics are just a guide and are not set in stone. Far more about this topic is included in our book *Securing the Future: Succession Planning Basics*, which was published by the PCPS. To shed some light on this here, we use the following as a general guide:

Senior Partner	1.25
Junior Partner	1.65
Supervisory Manager	2.25
Technical Manager	2.75
Senior	2.75
Staff	3.0
Bookkeepers	3.5

These should be base ratios and not what you aspire to. Plenty of reasons exist about why someone would fall short of the previously listed targets. The most common answers are (and you have seen them before)

- partners giving away projects and then blaming their write-offs on staff.
- one-off engagements requiring too much start-up time.
- too many nonchargeable hour duties assigned to a particular worker.
- a staff member who handles several firm exception clients. These are situations in which the work is billed way below standard because the client provides value to the firm in other ways. For example, that client refers a lot of business to the firm, the firm makes up for the low fees on this work because of the other projects it does for that client, and so on.
- a staff member handles our most unprofitable work. For example, many firms might perform a number of nonprofit audits for local organizations as part of community involvement efforts or because the firm wants those organizations on its client list.

Situations like these, and many others, will lower the multiplier ratio, and that's OK. However, the firm owners should be making conscious decisions about why they expect less profit from one employee versus another. Looking at each employee's multiplier, as well as by staff level, is also a great starting place for putting together an employee performance compensation plan. At the end of the day, if no reasons are easily identifiable for someone's ratio being too low, then it most likely means that you are simply not charging nearly enough for your people's time relative to what you're paying them. If this is the case, then raise the employees' billing rates to an acceptable level and then raise your project fees to accommodate those rates, and everything will start coming into line.

Growth in Net Revenues, Net Profits, and Net Profit Percentage

The value of growth in net revenues is obvious, and both uses are for a trend line perspective. It is a historical benchmark worth watching to see how fast your firm is evolving. It also is a good factor to consider as a predictive index to plan for where you will likely be in the next few years. Although last year's growth isn't an actual predictor of next year's growth, it is a metric that helps you see, over a period of time, what a low, high, and average growth expectation has been so that you can staff and prepare for likely changes.

Also, comparing your growth in net revenues with growth in payroll can give you an indication of whether you're keeping up with your increased costs of production resulting from annual pay increases, bonuses and overtime payments, and so on.

Net profits and net profit percentage are very straightforward. The blurred part of this calculation comes from whether to include guaranteed salaries of owners. For your internal use, it doesn't matter; however, when you compare your net profit percentage to other firms, this inconsistency makes it hard to interpret how you are doing against the benchmark. If you are a solo practitioner, your net profit percentage is likely to be 80 percent or even more. The bigger the firm, the more this percentage shrinks. Because net profit can vary dramatically from year to year due to a turn in the market; long-term investing in the firm (technology, training, and so on); tax planning; transaction timing; employee turnover; retirement; and so much more, a good net profit percentage is one that is consistent with your strategic plan and strategic budget. From a general perspective, if your net profit percentage is in the low 30s, you have some cleanup to do. If that percentage is in the high 40s, you might be relying too much on your partner group for your income or not investing in the firm at the level you should (see the following ratios on marketing, technology, and continuing professional education [CPE]). When we see net profit percentages between the high 30s and low 40s, we shift our focus to other metrics because we feel that range is a good general average.

Average Owner Compensation

Average owner compensation tells us how the owners are faring against the likely senior manager employees. From our experiences in working with firms, when we see an average owner salary of approximately \$150,000, then we know the owners are not making much more than some of the top people in the firm. As we previously stated, we like to see a meaningful gap in order to motivate nonowners to become owners. Why would someone

want to be an owner if he or she can make \$100,000 as an employee versus \$150,000 as an owner (and he or she might even be paying his or her own Social Security out of this) when such a pittance of additional money includes the risk of the business, the working capital needs and debt owed, and the future retirement obligations? So, if you are a very small firm and you (the owner) make a living that you are very happy with, you still need to think about building your business to a level that will make others happy. It doesn't matter that you can live comfortably on \$125,000. That is probably not enough to motivate someone to want to buy you out. If you are planning to try to merge, the firm you merge into is likely to be paying a senior manager about that much, so where are the extra profits for the owners to skim off to justify the effort of buying you out?

One of the problems with a lot of firms is signaled by average owner compensation. Most of the time, although problems need to be addressed in running a profitable organization, the most significant problem is that the organization has too many partners for the amount of business being managed.

Staff Turnover and Staff Additions

These two are the most commonly overlooked metrics we find when discussing firm strategy. They are the foundation data to understanding the hiring practices a firm needs to manage its growth. Some of you may be thinking, "This doesn't apply to me—I've got a small firm, and this is only relevant for big firms." The fact is that, unless you truly work as a one person shop, this does indeed apply to you. In fact, it's more critical for smaller firms than larger firms. To illustrate this concept, consider a firm with 20 employees. If 1 leaves, that's 5 percent turnover for that year, and although it may be a little uncomfortable, spreading the person's work around to the remaining 19 people should not be too difficult. Now take a firm with 5 employees. If just 1 of them leaves, that creates a gaping hole in capacity due to 20 percent turnover, with less people to whom you can spread the excess work left by the departing staff person. Now, let's compound the problem for both the larger firm and the small firm previously mentioned. If the owners are looking to train their people and push more work down while growing the practice, they need more capacity than they probably have right now. So, it's a double whammy in human resource availability that occurs in the context of demographic trends that leave us with fewer candidates for entry level jobs than we need.

For example, let's say we are working with a firm that has \$2 million in Net Revenues, 16 FTEs (an average of \$125,000 per FTE), 2 partners (an average owner book of \$1 million), and they have been growing at a minimum of 20% for the last three years. If you assume, for planning purposes, that their growth will continue at 20%, then the firm would be looking at Net Revenues of almost \$3.5 million in three years. If average revenue per FTE holds (and during rapid growth, it usually goes down, not up), this firm will need to have 28 employees by the end of the third year to do the work. This is a growth of 12 employees. When you consider the additional information—this firm has been experiencing a loss of two people a year (either due to termination or staff quitting); the firm believes two of their current people are very marginal (they can't let them go because of the current overload of work); and that they are at least one person short right now—an entirely different hiring plan starts to come into focus.

Based on this information, in order to be staffed to produce \$3.5 million in revenue in three years, we suddenly need to hire 12 new employees to manage the growth:

- Four for the new work we expect ($\sim \$2 \text{ million} \times 20\% = \$400,000/\$125,000$):
- Six new employees to reflect the two per year we have been losing;
- At least one staffer to compensate for the marginal employees being replaced; and
- One more person because we are currently short-staffed.

We essentially need to add 20 people by the end of the second year (they need to be on hand for year three if you want the capacity to grow to the \$3.5 million of revenue in year three), or 10 per year. While we understand that a reasonable amount of the \$1.5 million in growth will come from increased fees (so we could factor that into our equation), we also did not factor into this example the idea that a reasonable amount of the new people hired will be terminated or quit because the new job did not work out.

So, here is a 16-person firm, growing like a weed with the full expectation of continuing that growth, needing to hire at a rate of 10 people per year for the next 2 years to be in a position to do the work that will likely come through its door. Usually, these firms have a plan to hire 2 or 3 people at the most. This is why so many firms keep pushing their people so hard and keep running them off so quickly.

Remember, people are our “inventory.” When you run out of time to sell, your business will flatten. Yes, when you hire more people than you can keep busy, you have the risk of having excess inventory and not enough buyers, but we believe that this overcapacity is a short-term response. Worst case, just let go of that marginal employee you have been threatening to fire for the past five years. In almost every case, and we see a lot of them, the work comes in when firms hire good people.

On the opposite side of this spectrum, we also have seen the following happen when a firm tried to live with a labor shortage for too long:

- First, growth flattens, except for price increases, because there is no more labor to sell.
- Second, clients get frustrated with late work and leave.
- Third, because of the stress of keeping up with in-house project demand, good people quit, thereby reducing inventory.

Then, the firm struggles to find people to replace those who left, only to find the capacity of the new people is less than the capacity of the people who are gone (because the people who left already knew how to do the work and were familiar with the firm’s processes and procedures). Ask any retailer: learning to manage inventory is the key to success and profitability. As CPA firms, we need to do a better job of building time capacity and managing it.

Days’ Revenues in Work in Process and Receivables

Most CPAs probably have counseled their clients about the importance of these ratios and the importance of keeping them as low as possible. Yet, we find that many practitioners are sloppy about their billing and collection practices. We run across firms all the time in which 1 or more owners have more than 60 days’ revenues in work in process (WIP) and were just “too busy” to get their billing done on time. Similarly, it’s unfortunately not

uncommon to find receivables on a CPA firm's books that amount to more than 120 days of revenues. Now, if that same partner who was slow to bill also is slow to collect, then you're looking at up to 180 days (half a year) of cycle time to get the cash for the work done. You have two cycles to be attacking. The first is how long time stays in WIP and the second is how long until collection. The first one isn't that hard to manage. Sometimes, your billing practices are part of the problem. Rather than bill once a month, bill all the time. As soon as a presentation is made on project status, as soon as a certain time period elapses, as soon as a project is finished, and so on, bill it. Don't wait for some arbitrary cycle. Look at it this way: if you finish a project on the third of the month and don't bill it until the end of the month, you have thrown away 27 days (on average) of unnecessary interest against your line (or interest you could have collected).

Keep in mind that the longer you wait to bill someone, the less likely they are to recall the warm glow of success that you helped them create and the more likely you'll be having fee discussions with them and facing adjustments or write-offs. Ultimately, the more you can collect of what you charged, the better your net revenues per FTE will be, the larger your bottom line will be, and the more valuable your CPA firm, not to mention the quicker you can take that money home.

Marketing to Net Revenues

In order to convert your business model from an "Eat-What-You-Kill (EWYK)," or superstar, model to a "Building-A-Village (BAV)," or operator, model, you'll need to make a switch from relying on business development by individual superstars to creating and implementing a firm-wide marketing strategy. By marketing, we mean more than just advertising budgets; it includes all forms of business development, including promotional content on your Web site, handout pieces, meals with referral sources, seminars, advertising, and more. This will take resources to carry off. It will require conscious decisions about the types of clients served and services offered. Most CPA firms devote entirely too little funding to marketing. How much marketing is enough?

Yes, we get it. Why spend this kind of money when you have an owner who is great at it? We hear it all the time. You would just be spending money that you don't need to spend because he or she can bring in all the work you can do. Well, the longer you operate under the EWYK model without backfilling with supportive operating processes, the more likely that superstar will eventually start holding the firm hostage. The superstar will likely demand a premium in salary or require special perks, such as an unreasonable retirement benefit, more ownership or control, and so on. Leverage your superstars' skills but don't rely on them solely, or the price you will eventually pay will easily be 10 times what it would have cost you to operationalize the same growth engine.

What should this number be? Interestingly enough, this metric has fallen off the critical radar list in the last 2 years. Why? Because right now, most firms have all the business they need and are focusing on getting their people trained to do the work in-house. However, from looking at the data over the past 10 years, this has commonly averaged less than 1.5 percent of net revenues for the average firm. Many firms are now catching on to the importance of institutionalizing marketing, and they are spending in excess of 5 percent on

those processes. Generally speaking, your marketing budget should probably average approximately 3 percent, hitting 4 percent to 5 percent every couple of years just to keep your messages in front of your clients and referral sources.

By the way, this is not a fully allocated number. So, if a partner is responsible for marketing, then we would not allocate part of his or her salary to this category. Also, you would not charge the marketing budget with partners' time managing their clients (which is how a lot of new business is generated). You would, however, include the expenses for lunches and so on. Also, if you have someone whose full-time job is to manage marketing activities, this person would be included in the numerator.

In regard to marketing expenses, some firms buy a luxury box at a stadium, sponsor a local golf outing, buy seats at local theaters, and so on as part of their marketing plan. Nothing is wrong with this, and it can be quite effective, but you are basically using the marketing funds to support a personal interest of the owners, so at least be realistic about the expected return on these funds. Owners commit to using these types of perks to generate business all the time to convince the other owners that this is a valuable use of funds. However, after the first game or two, these perks often go unutilized, or they are used by the same clients, family, staff, and so on. We are not saying this isn't valuable; we are just trying to say it is not marketing. It might be part of staff retention or something else just as worthwhile. The point is to make sure that you use your marketing funds so that they support the firm's marketing efforts. If you don't, then, at least for management purposes, fund your marketing program with a reasonable budget and then roll those disguised perks back in on top.

Technology to Net Revenues

We have three basic ways to crank out work: (1) we can use people to do the work and bill for their time, (2) we can highly leverage technology to make our people more efficient in order to increase throughput through our limited human resources, or (3) we can leverage people outside of the country through the use of technology and outsourcing. Given the difficulty of finding, hiring, and retaining staff, we believe firms should be looking for every possible way to incorporate technology. Why? Because technology is a plentiful resource but people are not.

Successful CPA firms are not only looking at technology to help assist with labor intensive administrative work; they are looking for ways to utilize it for strategic advantage, as well. Technology has become integral to the practice of accountancy, so your firm should have a technology plan with specific strategies (and budgets) to make sure you are utilizing everything your hardware and software have to offer.

Although general ledger accounting and electronic spreadsheet software applications have become more or less ubiquitous, we find that CPAs are still not making use of them as they could. In this day and age, it's hard to imagine an accountant not being at least at a beginner's level of skill in using spreadsheet software, but we've run across some who still prefer green columnar pads and pencils to Excel. Now, skip to the next level of technological sophistication, and look at the potential benefits of electronic working papers—the "paperless" audit and tax return. At this time, most firms have at least begun to embrace this

technology, with many of them being four or five years into this process. What about digital phone systems that allow multioffice firms to call between offices essentially on an intercom, saving long distance costs, as well as making it seamless to the clients when they need access to the firm's talent? We believe that every dollar spent on technology that helps leverage the time of staff is the best money you can spend.

For those firms fighting technology, this is a battle we don't believe you can win. Not only are your costs going to rise (people cost too much), finding additional capacity will be your albatross to carry. However, the software application market is changing. Key providers of accounting, tax, and audit software are moving toward enterprise systems: everything integrated, everything connected. This evolution is forcing firms to select one vendor for all of their accounting software rather than have a potpourri of best-of-breed applications running. As the old saying goes, "If you can't beat 'em, join 'em."

Finally, for succession purposes, the more your firm uses technology, the more valuable it will be to a buyer or merger. Most large CPA firms have embraced technology. If you and your people are accustomed to working with up-to-date enterprise (integrated) software performing your specialty functions, then the acquiring firm knows that the learning curve to get your people up to speed with their processes will be quick. If your people follow processes of their choice, with each of them deciding what technology to use, this retraining to bring your people into the 21st century will come right out of the bottom-line offer you will receive.

One other point: When we hire people, we have no problem charging for their time to create a profit. When technology played a lesser role in our profession, many firms at least tried to recoup some of their technology costs by showing the service bureau fees in their bills. Today, we are using technology to find every way possible to leverage our people's time, and our technology budgets are significantly higher than they have ever been before because of it. No, we are not suggesting putting in a technology charge on your bill again. However, we are suggesting that technology be considered a cost component of each hour of work performed. Therefore, you need to be writing up WIP to reflect the real cost of operations, and once you write up WIP, you need to work with the owners to make sure the new fee pricing reflects an adequate amount to cover this. We work with firms that will write up WIP almost 20 percent to reflect the profit recovery they expect from their technology investment. Our point is that when you substitute technology for people, you also have to find a way to make money on that technology. Otherwise, you should revert back to all manual processes. At least that way, you will allow yourself to bill an appropriate amount for the work being performed.

What is a reasonable budget for technology? As you saw in the survey numbers in chapter 2, the average in our succession survey was approximately 2 percent, but this is a little low. Similar to marketing, it should probably average 3 percent, with that number spiking to 5 percent or more approximately every three years. We know that technology spending has been up in recent years, so it being down for our recent survey didn't surprise us. Just as with marketing, the cost of people or consultants hired exclusively to support your technology would be included in the numerator but not an allocation of the cost of an owner who

might have management responsibility for this area. As we said, technology spending often has a spike effect, with significant dollars spent to upgrade the hardware and software in the first year and less money required during the next few years in order to implement all of the functionality just acquired.

Training (Continuing Professional Education) to Net Revenues

We've saved the best for last regarding operating expense line items as a percent of annual net revenues. Training (continuing professional education [CPE]) is huge in the CPA profession. Just look at the annual technical CPE that most CPAs attend to maintain their licenses. Yet, when you calculate the percentage of yearly net revenues that comprises CPE, it has been running less than 1 percent for at least the last five years. Now, that's pretty interesting when you consider that our "inventory" and capacity to earn revenues are based on people, which are our most critical and scarce resource. To be able to make the changes required for successful succession now and in the future, no metric is more important to monitor than this one. Everyone in the firm will be required to learn some new skills and behaviors, from the owners on down through the ranks. They are not going to learn the necessary skills with just on-the-job training (OJT) because emulating their current boss may be the worst behavior they can adopt.

To fill the missing talent gaps with competent staff, more time needs to be devoted to training and education on a routine, ongoing basis. CPAs will need to learn how to better manage larger books of business and how to better manage and develop their people. Much of what this will entail is learning some of the qualitative, nontechnical skills (often referred to in somewhat of a misnomer as *soft skills*).

We believe that the successful firm of the future will be spending even more on training than we are suggesting for either marketing or technology. Most firms will need to consistently spend 3 percent to 5 percent for at least the next 5–10 years or maybe forever. Training has become a best practices issue because many firms are setting their minimum training standard operating procedure at 80–120 hours per person per year or more. In today's market, this not only helps the firm advance the skills of their personnel faster (therefore reversing the upside down pyramid more quickly), but it also becomes a competitive edge in recruiting and retention. For those who feel like no one spent this kind of money on them and, therefore, they shouldn't have to commit this level of resources for their employees either, suffice it to say that someday the labor market will shift from a shortage to a surplus. When this happens, because many people will be fighting for few jobs, firms can go back to the old way of "survival of the fittest" and quickly cull those who don't build the skills they need on their own. However, if you think the marketplace will permanently shift back to a "survival of the fittest" model in your lifetime, we hope you aren't holding your breath.

Staff hired exclusively to support the training function would be part of the numerator. The good news is that although we have a gap in talent between partner and staff and because most firms have not focused on training at the proper level for a long time (maybe never), we can close this gap fast with a concerted effort. It should only take about two years to build what we refer to as a five year skilled CPA. Why? Because in today's model,

we leave these people alone except for OJT and CPE. It takes them about five years to get two good years of training. So, although we have a steep road to climb, firms that make this a priority will get there much faster than they think. Remember, they're not called human expenses, they're human resources. Consider also that staff are demanding more training, development, and skill building from their employers. If you want to attract and retain quality staff, you need to sell them on your development and career path processes.

More on Performance Metrics

For those firms that want to take performance metrics to a higher level than we are discussing, we have an example provided by Brotemarkle, Davis & Co. LLP from St. Helena, California, for your review. They not only offer strategic performance measurement consulting to their clients, they apply these principles to their practice. Everyone in the firm is involved annually in the creation of the measures, and they decide what the appropriate rewards will be once they achieve them. Recently, they all took a trip to Cabo San Lucas as a result of hitting their targets (see appendix A, "Defining Protocol for Implementing Performance Standards," for more details about this year's target metrics and process).

Strategies for Improvement

Now that we have gone over performance metrics that will help you identify areas where your firm could use some focus, here are some strategies to consider for improvement. In order to position your firm for a positive outcome in your succession planning, you may need to address several of the following areas:

- Overall firm strategy and vision
- Business model
- Management and governance
- Standardized procedures, which include the following:
 - People management and development
 - Marketing
 - Managing book size
 - Client acceptance and retention
- Improving the bottom line

Overall Firm Strategy and Vision

Every business should have a defined strategy and vision of what its future success will look like. This helps create the context for the rest of the decisions that must be made on a routine basis for the firm. As Yogi Berra said, "If you don't know where you're going, chances are you will end up somewhere else."

The first step in cleaning up your firm's operations is to be clear on where your firm is headed over the long run. This means that if there are multiple owners, you achieve agreement on the general direction and focus of the firm, as well as what it means in commitments from individual owners. If one or more owners are unwilling to go along with the overall direction of the firm, then that is too bad. They either need to be held accountable

for taking steps to help achieve the strategy or let go. You can't get anywhere if the majority of your partners are out raising the sails to catch the wind while a couple of other partners are running to the back of the sailboat to throw out anchors.

It's important to have a sense of direction for your practice before you set about making a variety of operating changes or pursuing new entrepreneurial opportunities for the practice. Without a clear sense of direction and focus, every idea seems like an opportunity. Your strategy helps you build a sanity check to verify which ideas are truly the opportunities worth pursuing.

Take some time and determine what your firm should look like at the end of the next three years. Make sure that you, as an owner of the firm, factor in your personal vision for your future. Your personal vision and your firm vision are inseparable. Regardless of your vision, whether it is to keep working, buy, sell, merge, effect an internal buyout, or any other option, once you have a strategy, you will find that you more wisely spend your time and better utilize your resources to position yourself and the firm for the most positive outcomes.

Business Model

We've characterized the two most common business models used by CPA firms as the EWYK model and the BAV model. (We introduced this in the first chapter.) As part of strategy development, CPA firm owners should discuss their current business model and their desired future business model. At certain times in a firm's growth and development cycle, one model will be more applicable than the other to that particular firm.

Smaller CPA firms (approximately \$2 million to \$5 million in annual volume) typically employ the EWYK model, in which the owners are rewarded, for the most part, based on what they produce through their book of business. The owners share operating costs, but for the most part, they practice and manage independently of one another. The firm's staffing policy results in recruiting people to support the superstar as he or she continues to obtain and perform work for the growing client base that sees him or her as the embodiment of the firm. The EWYK model works well in start-up firms because the start-up firm requires a person willing to do everything, from getting the work to getting it done and being willing to live on whatever is left (even though he or she could make more working for someone else).

At some point, as the firm grows, its clients' needs expand and its service offerings expand to meet those needs, and the business model should start to morph toward a BAV model to handle the changing complexity and manage practice risk effectively. One person is limited in the amount of business he or she can manage, minutiae he or she can process, and pots in which he or she can keep his or her fingers. At some point, the superstar operating in the EWYK model can't manage it all, and clients begin to be underserved, professional staff are underdeveloped, process and procedure is almost nonexistent, and so on. Think of it this way: imagine one person spinning 5 plates on a stick, then 10, then 15. At some point, he or she can't keep all of the plates spinning without taking a different approach. Otherwise, the plates will start falling off and breaking until the remaining number becomes small enough for the superstar to manage again.

To continue to grow profitably, the owners must be able to leverage their work, pushing down manager-level work to managers, with managers pushing down staff work to the staff. Owners should become client account managers who oversee client satisfaction and provide high-level advisory services, and the rest of the work should be leveraged through the other people working in the firm. This requires the development of delegation and supervisory skills for partners, managers, and experienced senior professional staff. The more this type of infrastructure is created, the more the firm is developing a BAV model.

Just because a small firm's owners have a large and profitable practice, it doesn't follow that they will realize a high selling price on transfer of their practice. This is because, using the EWYK model, the clients are all looking to the owners to handle their work and meet their professional needs. When the owners leave, it will be difficult for the buyer of the book of business to hold on to those clients. This is true no matter how well the new firm services the clients and no matter how robust the transition process. What we are saying is not magic. Any time a firm builds one-on-one relationships, instead of many-on-one (institutional, team-based relationships), it's much more difficult to maintain those relationships when the one person (the owner) leaves.

Additionally, buyers want to be able to buy books of business that have skilled people available to work them. No one is really overstaffed in this day and age, so a book of business, no matter how attractive the individual clients, is less attractive in a sale or merger transaction if the seller doesn't have adequate or adequately trained staff. Unfortunately, an EWYK model creates a paucity of trained staff and will result in a lower realized offer. Consider the example of a sole practitioner's book of business that sold recently in a small, rural area. None of the other local firms were interested in buying the practice because they were all extremely challenged with staffing for the work they already had. Consequently, the seller had to engage firms from out of town to take over the book of business: one firm for the audit business and one firm for the tax business. The seller immediately had some clients leave to go to other local firms in town because they didn't want to deal with out-of-town CPA firms. Had the firm been converted to a BAV model, with appropriate staffing, prior to the sale, the seller would have had more sales options and would have realized more value from the transfer of the business.

The bottom line here is that, whether you want to sell your practice, merge it into another firm, position your practice to merge other firms into yours, or sell to your own people, you will be better off if you have a functioning BAV model in place. It takes several years to make this conversion, so you need to start this process now. If you are planning on someday just turning out the lights and walking away, you can probably get along with a continuation of your EWYK model. Recently, we had a conversation with one of our clients who planned to turn the lights out when he left, and when he realized how much money he could be walking away from by taking this approach, he immediately changed his approach. His conclusion (maintaining his current EWYK model was going to limit his options in the future, and the BAV model didn't lock him into anything specific) was that adopting this model just gave him more possibilities to choose from when he was ready to go.

Management and Governance

The appropriate form of management and governance for decision making goes hand-in-glove with the business model decision. For multiowner CPA firms with owners who want to be assured of being paid a benefit by their partners when they retire, they will need to move beyond the business model under which they basically run their own books of business and merely share overhead and staff. Why? Because if I am a coowner of the firm and I am being obligated to buy you out when you retire, then I better have a say in the kind of practice you are allowed to build, as well as how you operate it (client acceptance, processes you follow, collection, level of delegation, fees billed, and so on). In order to implement this level of oversight, multiowner CPA firms need to embrace a corporate governance model in order to have everyone pulling in the same direction for the benefit of the firm and to achieve the shared vision for the firm. With a corporate model of governance

- the firm owns the clients.
- the actions of the partners are in lock-step with the firm's goals.
- a clear delineation exists between being an owner versus having a say in every decision.
- roles and responsibilities, identified limitations, and powers for those positions (board, managing partner, firm administrator, and so on) are established so that everyone can be effective at their jobs.

The owners act as the board of directors, electing a managing partner and holding the managing partner accountable for overall firm results. The managing partner holds each individual owner accountable for individual goals, as well as for supporting the firm goals and direction. Under the corporate form of management and governance, the CPA firm is managed like a business. What is funny is that we ask the following question a lot: "How many of your successful clients operate in a management-by-committee model?" Never once have we had someone give us an example of this being successful. We then ask, "So why do you think your firm will be the only exception?" The committee model of governance results in lack of accountability, at best, and management decisions being made by the vocal minority, at the worst.

For example, a firm with 5 owners was managed by a partner who owned 30 percent of the equity. One other partner owned 20 percent, and the remaining 3 partners each owned 15 percent to 20 percent. The partners would have partner meetings and seemingly make decisions as a group, only to find at the next meeting that one or more hadn't been followed. Sometimes it was due to inertia on the managing partner's part; at other times, it was the result of 1 or more of the other partners not being held accountable by the managing partner. Consequently, their agenda of planning issues never really changed from meeting to meeting. No one—not even the managing partner—was held accountable. As a result of this, their key producer, finally fed up with the passive-aggressive culture and overall ineffectiveness, left the firm. The rest of the partners are still talking about the same planning issues, though.

If you are looking at selling or merging upstream, you need to have an effective form of governance in place if you want to make the changes necessary to clean up your

operations and maximize profitability, thereby increasing firm value. Now, understand that it's not mandatory, especially if you are willing to take less for the value of your practice. On the other hand, if you intend to merge other firms into your firm, converting to a corporate form of governance is absolutely necessary. You can't expect to successfully merge other practices into yours without having good decision making and implementation infrastructure in place. Throwing together two or more ineffectively managed firms creates a geometrically increased level of chaos. Over and over, we have heard CPA firm owners agreeing to merge and take the best of both practices. Unfortunately, what emerges is the worst of both practices because of the exponential political playing field created. When you merge firms into yours, the answer is clear and up front: the merging firm follows your rules, processes, policies, and culture. If the management group chooses, it may adopt a best practice from the merging firm.

If you believe you just want to turn out the lights someday and walk away, then you are practicing as a solo owner, and the form of governance becomes whatever you want.

Standardized Procedures

Two levels of standardization should be considered as you clean up your firm's operations to ready it for your exit strategy. At the day-to-day operations level, standardized procedures should exist for accepting new clients, setting up their files, (whether electronic or the old-fashioned paper format), doing the work, documenting and reviewing the work, communicating with clients, billing, collecting fees, and so on. Similarly, you should have some level of standardization for recruiting, hiring, performance appraisals, disciplinary discussions, pay increases, bonuses, and terminations of employees. Having best practice-level standardized procedures allows your people to focus on doing the work and meeting client needs as seamlessly as possible, regardless of whom the client is or the owner that manages them. Your staff shouldn't have to recreate the wheel every time a new activity is performed. If someone is out sick and another staff member has to step in and finish up the work, there should not be any guessing about how the work was approached, what stage of completion the work is in, and how it should be completed.

Standardization also makes it easier to train new people because everyone does the work the same way. Unfortunately, at many multiowner firms, we frequently hear complaints from staff that it is very difficult to remember the nuances that each owner wants them to follow. The staff often feel like it is hard enough learning all of the technical aspects of their work without having to remember the petty differences in working papers or allowable actions, depending on which owner manages the client. This confusion requires unnecessary time and multiple learning curves, not to mention the fact that it's one of those factors that makes work less than pleasing for the staff the firms hope to retain.

At another level, standardization also is necessary in terms of standard operating procedures for firm governance, management, and administration. For example, standard operating procedures should be in place to cover what types of decisions are made by the managing partner (based on articulated limits and authority) and what types are made by the partner group as a whole acting as the board of directors. For instance, day-to-day operational decisions are logically the managing partner's responsibility, within the budget and in

line with the objectives and goals set by the board. However, in broader strategic areas, such as firm strategy and partner compensation, although the managing partner might develop some draft plans for consideration, the board would have final approval. Standard operating procedures with clearly defined roles and responsibilities are essential to supporting seamless leadership changes. Without this infrastructure, every new leader will act like a pendulum swinging the firm in his or her personal direction or choice, or even worse, he or she will fill the position as a figurehead with virtually no authority to implement anything.

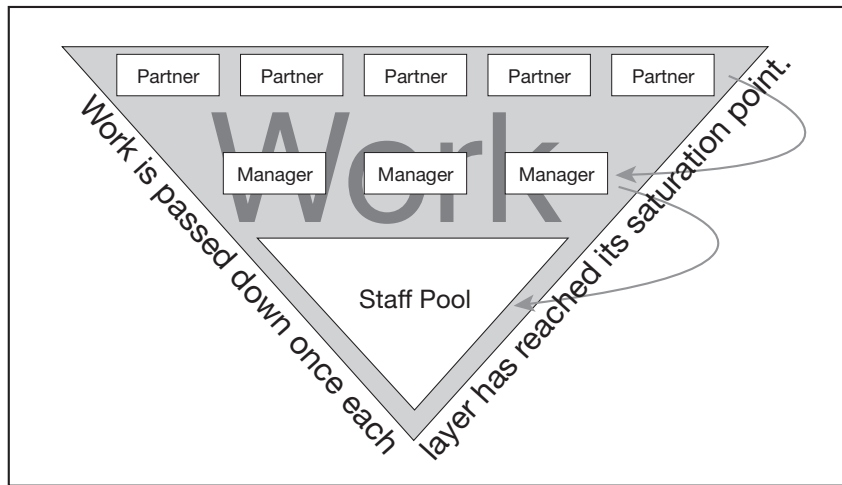
The more discipline that you create by doing things consistently, the easier it will be for you to manage your business and generate excess profits. In addition, this type of operation is of more value to other firms because you follow processes rather than the superstar's whim of the moment. Even if your new firm's procedures are different from the way you've been doing things, the fact that your people are used to working with standardized, defined ways of conducting business makes the cultural transition far easier for everyone.

People Management and Development

The Upside Down Pyramid

As covered in more detail in the book *Securing the Future: Succession Planning Basics*, during the last few decades, public accounting firms have dramatically expanded the scope of services they offer. Many of these services have been in specialty areas, from being aligned by industries such as auto dealers or health care to services such as business valuation or fraud detection. When these services are launched, they are typically championed by an owner, principal, or someone highly respected within the organization. Because some of these areas have sporadic demand or require a high level of expertise, firms often have relied on these same senior people to manage and do the bulk of the work. Based on our personal observation, this has supported a trend in small to midsize firms to build a workflow process that looks like an upside down pyramid (see figure 3-1). For many firms, this operating environment functions as follows:

The lion's share of the firm's income is generated by the partners and managers. The partners and managers are very hands-on and involved in the details of most client projects. The workflow hierarchy is a trickle-down approach. Partners do the technical work until they have worked all the hours they can stand, and then the excess trickles down to the managers. The managers do the technical work until they have labored all they can stomach, and then the remains trickle down to the staff pool. In each case, keeping the workers at the next level busy is almost an afterthought.

Figure 3-1: *The Upside Down Pyramid Workflow Process*

The Problem

It is as if these firms have an attitude that the subordinates are employed to do the work that their superiors don't want to do or are considered to be administrators, providing assistance when needed. In the upside down pyramid environment, partners and managers are overworked, and staff is underworked and poorly trained. The problems created by this process are discussed in more detail subsequently.

Partners Doing Nonpartner Work

This workflow process can easily harm the profitability and long-term viability of the firm. For example, instead of pushing work down to the lowest level possible, it is almost done in the exact opposite way, and work is performed by the most experienced person possible. Although one could surmise that this approach would garner higher fees (because the work is performed by people with higher billing rates), most of the time, that assumption is wrong. For much of the work we do as CPA firms, our total fees are either fixed in fact or fixed in presumption. Obviously, fees are fixed in fact when a specific project price was specified. The fees are fixed in presumption when we do recurring work, such as preparing a tax return each year, and the client assumes that this year's fees will be similar to those charged in previous years (unless the scope of the work changed).

So, if you consider that much of our work is fixed in price, then using more experienced people than necessary to do the work could create larger write-downs or, even worse, consume the most scarce resource a CPA firm has—owner time. If you take the position that your more experienced people do the work faster so that write-downs are not a factor, then we would respond with, “We bet there is higher-level work your experienced people are avoiding that should be done by them instead.” When partners or managers tie themselves up doing work that is below their capability, they are not only doing work someone

else could do at a lower rate, but they also are diminishing the amount of time they can devote to work that only they can do.

Undertrained Staff

Another fire that this reverse workflow pyramid lights is undertrained staff. Because these firms follow a work first, manage second strategy, at every level of the firm, people are poorly trained. The reason why is simple. It commonly is, “If I were to give this work to someone below me, I would have to spend so much time supervising him or her on the project that it is just quicker to do it myself.” Our response is, “Both the roles of partner and manager are based on the philosophy that you are supposed to get the work done through others.” As a manager, that title is descriptive of your job—to manage. Otherwise, your title would be *doer*. So, the next time you hear yourself utter the words, “It will take too much time to train my people to do this,” then stop right there and remind yourself, “Hey, although it may take longer, my job is to train them so that they can do this work.” By the way, another classic reaction from this reverse workflow pyramid is that employees rarely get feedback on their work. Instead of the partner or manager sending back a list of errors for the originator to fix, the senior people reviewing the project just correct it and get it out the door. Once again, this group demonstrates why the shirking of their responsibilities is creating employees below them who lack the necessary competencies.

Partner Conflict

Finally, this upside down process stimulates partner conflicts. This model has little financial leverage, which creates economic frustration. Conflicts arise because of the disparity of roles and duties between partners. Some partners are stepping up and embracing their responsibilities, but others are functioning in the safe and unchallenging space of being glorified managers (unchallenging only because that is what they were doing before becoming a partner, so they are hiding in their previous jobs).

Hiring of Staff

The key resource and the potential source of competitive advantage for any service business is its people and the intellectual capital they bring to bear. CPA firm owners need to ramp up their people management and development skills if they ever hope to retire and realize a modicum of value from their books of business. Keep in mind the fact that skilled talent is at a premium throughout the CPA profession and other industries, and it’s not going to get any better. You are competing with these other industries for people, and most of these industries don’t carry the busy season overtime hours baggage of public accounting.

Many firms continue to pursue a strategy of attempting to hire experienced staff. The smaller the firm and the more remote its location, the less likely it is that this strategy can be effectively executed. In today’s environment, it doesn’t matter how big you are or where you are located. If you find an experienced professional to fill an open position from outside the firm, you are either extremely lucky that someone’s career and life needs happened to mesh with your firm’s needs, or you are hiring someone else’s problem and making him or her your problem. To be sure, some talented people get hired into CPA firms through retained searches, but many of them are the “hired guns” who will come to work for you at

an outrageously high salary and then leave in approximately 18 months for an even higher compensation package at the next firm.

So, what's the answer? You may not be pleased to read this, but you need to hire them and grow them yourself. Sure, it takes time, but this approach is the only way to begin turning the upside down pyramid right side up. The good news is that if you have several years to retirement, you can make this change and improve the value of the business for you and for those owners who are left in the firm after your departure.

Previously, you read about the need to ramp up hiring in general to be sure that there's enough capacity to allow you to clean up your operations while growing profitably. If you're looking at selling or merging upstream, be sure you have enough staff to get your work done profitably. If you are merging others into your firm, you also need to be sure you're adequately staffed because some of the candidates that you bring in for a merger may be short a person or two already. As a matter of fact, if you are the acquiring firm and you have additional capacity, you should be able to buy some firms at a nicely discounted price in the near future because a greater number of firms are becoming more interested in the people than the revenue stream.

To find younger people to bring into your firm, you should consider establishing relationships with local colleges and universities, getting involved with student accounting clubs, and participating in scholarship and intern programs. For example, one CPA firm with seven professional staff acquired four of its staff through an internship program at the local university. As you spend more time in this environment, you will likely find that you could benefit from some training in effective screening and interviewing techniques. Gaining some background in these areas will prove valuable. Of course, although you can stack the odds in your favor of finding people who are a nice fit within your organization by improving your interviewing and screening skills, you will always be surprised by a reasonable percentage of the people you hire.

Development of Staff

Once you hire all these new people, you need to accelerate their growth and development. We don't have the luxury of using the old ways of developing people to generate a five-to-six-year senior. We need to be able to shorten that cycle time to three years or less, and this development is only done with a conscious, structured effort. Gone are the days when a CPA relied solely on 40 hours of classroom CPE and OJT in the form of clearing review notes to develop his or her people. Accelerated personnel development requires a combination of several of the following activities:

- Identification of key competencies required for success in a position
- Gap analysis to identify developmental needs with respect to these competencies
- Routine career development meetings (no less than quarterly and preferably every 30–60 days) with staff to review gaps, assign development activities, and monitor progress
- Training and education in the following:
 - Delegation and supervision
 - Communication and other interpersonal skills
 - Other skills required by your competency models

- Project assignments specifically chosen to address skills required by your competency models
- Active coaching by supervisors of their direct reports to help set expectations and provide feedback on achievement and developmental progress
- Formal mentoring in firms with sufficient number of staff and supervisory personnel
- Traditional CPE to build technical capabilities
- Traditional OJT in performing various aspects of the job, including clearing review notes

Retention of Staff

We often hear CPA firm owners tell us that they are concerned that they will put all of this time and money into developing their people and then their people will leave. Our response is, “Would you rather have them be untrained, uneducated, and underdeveloped and stick around?” The fact of the matter is that providing the kind of development opportunities previously mentioned will go a long way toward keeping quality people. Although paying market rates is just the ante to get into the card game of staffing, providing your people with clear expectations and then letting them know how they’re doing is a key factor of job tenure. Just as important to them as money is the opportunity to build their skill portfolio, thus making them worth more in the marketplace.

Additionally, younger CPA firm professionals want to know that they are working on something important—that what they do matters. This is where having a clear and well-articulated vision for your firm (one that is truly used to drive action at the firm) pays off in spades. Most of your staff will be more inclined to stay with you if they believe you have an overall, guiding direction; that you are marching toward it; and that they have a meaningful role to play.

Finally, continuing our card game metaphor, the culture at your firm is the true ace in the hole for staff retention. Simply put, culture is “the way we do things, and the way we treat people around here.” The following questions illustrate how your culture is a direct reflection of your firm’s values:

- Does your firm culture support staff development and understand that when people learn new things, mistakes are an inevitably part of the process, or do the owners punish mistakes and send out the message to “only do what you know how to do”?
- How about communication? Do your owners maintain open lines of communication with your people and are they approachable, or do the owners constantly work in their offices behind closed doors, impatiently waving off anyone who tries to get their ear for a question?
- What about the quality of life at your firm? Does quality of life mean spending your life at the office working without questioning the overtime required to be put in for marginal clients? Do you really provide an environment that is family friendly and allows people the flexibility to get their jobs done and still have time for a meaningful life away from work?

Job flexibility is just another key piece to retaining quality people. They don’t care what you did to earn your ownership position in “the good old days.” In fact, for many of them,

if advancement and ownership mean that they have to work unusually long hours (in their view), they'll eschew the advancement opportunities in trade for freedom, and you may find them working at your clients' businesses instead.

Owner Training and Development

The biggest barriers to flipping over the inverted pyramid are the CPA firm owners. Developing and carrying out strategies suggested here are not really difficult; they just require some different skills, activities, and behaviors than many CPAs have become accustomed to. The good news is that this is all learnable, and like anything else in life, if done with some forethought and preparation, you can make some serious progress without running the risk that you'll end up living on the street some day. However, it will require you, the owner, and your partners in training, to do the following things:

- Learn some new management skills
- Learn to live with some discomfort and ambiguity as you begin making changes

Marketing

Even though most firms have been unintended beneficiaries of the Sarbanes-Oxley Act of 2002 and other government regulation and legislation, you can't count on government regulation to support your business growth. The next major legislative package may do just the opposite and shrink demand. Even if the business development rate is unusually high in your market area, clients will leave for any number of reasons, including mergers upstream, business sales, business closures, deaths, and life changing health problems, as well as occasionally being ticked off at your firm for service breakdowns. Because of this, marketing needs to be a constant in any CPA organization.

As you put your marketing plan together, you'll be looking at concentrations of businesses, such as what industries or service offerings seem to offer promise and how you might pursue these opportunities. The most successful marketing strategies find ways to synergistically grow the practice by getting more share of the firm's existing clients' work while adding new clients who fit in with the offerings of the firm. Beware of creating what we call "island" service offerings that don't capitalize on any existing synergistic client relationships. These offerings can take a long time to ramp up to profitability. When the service lacks synergy with the other services the firm offers, you may just find yourself spending hard-earned profits today to incubate one of your people's spin-off specialty firms once that business starts making money.

When we talk about marketing, we're talking about strategizing about whom you'd like to work with, where, and providing them with what services. We're talking about creating a holistic approach to driving referrals to your firm and winning the work that you've decided to pursue. It may include some advertising, but advertising really should play a minimal role in your efforts. Certainly, some benefit exists to keeping your name in front of your marketplace. This kind of visibility reinforces that you're a player in that community, industry, or area of expertise. However, the way that most new work comes in (90 percent or more) is through word-of-mouth referrals. So, that is where you need to put the lion's share of your marketing dollars.

Don't waste scarce resources on splashy Yellow Page ads, television commercials, or newspaper advertising. Although these might be great for the owners' egos, they won't do much for business development. Your clients didn't decide to use you by looking up *CPA* in the Yellow Pages. We are in the relationship business, so your future work will come from the relationships you establish, from clients' needs or the needs of people in their network. So, start taking better care of your top clients and make sure that you're in front of them at least quarterly. Do this with key referral sources, as well. Regularly send out e-letters and position papers on topics of interest that showcase your expertise to clients, prospects, and referrals. Get actively involved in your clients' trade associations.

Hold yourself and your partners accountable for maintaining visibility within professional networks, as well as staying in close contact with clients. If you feel that you don't have time to do this, go back and re-read the "Development of Staff" section. You need to delegate more of your less important tasks to others so you can free up time for activities like these that you are not only supposed to be doing but that you are best suited to do.

Managing Book Size

Balancing the book of business is one of the largest stumbling blocks for CPA firms. For most firms, it is difficult to resolve because it is symptomatic of some real trouble brewing.

Optimal Book Size

The optimum condition for firms to flourish is for books of business to be balanced throughout the firm. From the largest book to the smallest, the percentage gap between them should be fairly small (approximately 20 percent to 25 percent or less than a couple hundred thousand dollars in fees). Often, the gap is small when firms first start and is a nonissue. All the partners are working hard just to get the new firm off the ground, and although one partner's book might be \$400,000, the other one's is \$300,000. In this example, the same style of client management would likely be utilized by both partners, with the partners doing most of the work on each client project and utilizing staff for the more menial tasks.

However, as firms grow, so does the difference in book size. If a partner wants to be very hands-on with each project, then that partner will hit a natural book size ceiling that he or she can manage. Our experience says this ceiling is about \$500,000–\$700,000 of work. Some partners adopt a less hands-on philosophy regarding project management and gravitate more to client management. These partners will utilize staff to do the lion's share of the work. These highly leveraged partners (those who delegate most of the project management to staff) can easily handle a book size of more than \$1 million, and many can handle a book size of approximately \$2 million or more.

Now, just for clarity, we are not talking about the 50 largest CPA firms with partners having a \$2 million client management ceiling. In the largest CPA firms, one partner's book size often will be significantly higher because one client may be \$50 million per year in fees. So, although we don't want to get too far off the point, when we refer to one partner managing a book of \$2 million as another natural ceiling, we are thinking of firms that have total net revenues from \$2 million to \$5 million. These firms have little, if any, Securities and Exchange Commission work, and a very large client would be a couple hundred thousand

dollars in fees per year, with most large clients generating around \$400,000 in fees per year. The maximum book size a partner can handle is based on three components, not just one. At some combination of number of clients, fees collected for each client (scope of projects), and number of projects, the amount of activity becomes too much for one person to stay on top of if he or she is focused on maintaining high client service and satisfaction levels.

Negative Contributions of the Small Book Partners

Don't worry if this describes you because, subsequently, we focus on how and why large book partners are causing as much, if not more, damage to the firm.

When a partner, because of his or her client service style, has a maximum work ceiling of \$500,000–\$700,000 in book size, he or she is likely hurting the firm. Why? Many reasons come to mind. The first is leverage because there is little of it. The partner in this situation typically does too much of the detail work. Immediately, this causes a realization problem because much of the work does not warrant partner billing rates. Therefore, we write down the work and complain about fee pressure when, in fact, it is more about misallocation of personnel on the project.

Another byproduct of this misallocation is the underdevelopment and underutilization of managers because the partner is doing manager-level work. This tends to relegate managers to doing staff-level work and so on down the organizational hierarchy.

Under this scenario, one more downside anytime most of a partner's time is committed to working on the details of projects is that virtually no time is left to spend with clients and trying to live up to our profession's mantra of being their most trusted adviser. It is almost impossible to be a client's general business adviser if you rarely spend time finding out what is on their mind and what is important to them. If the partner doesn't set aside time to do this, you can guarantee no one else in the firm will.

An additional negative aspect of small books is profitability. In a \$500,000 book, after paying staff and overhead and once the compensation for the partner who is managing the book is factored in, little is left to share with other partners or to grow or reinvest back into the firm. Even in the rare cases when a reasonable amount of profit is left, regardless of how much you grow the firm, this partner's contribution to the bottom line will remain fairly flat.

One common complaint we get from firms with significant growth opportunity is that they are struggling to find new partners to manage the additional work. A similar story is often told by firms with retiring partners: no one wants to take on the additional client load. The problem cited is that all of the other partners have as much work as they can do. For the record, this problem is all about capacity and freeing up more of it. The starting place to build this excess capacity is to force partners into living up to their partner roles and responsibilities.

Also, the tendency is for partners with small books of business to over-serve their clients. Because they don't have as many clients and as much work to manage as partners with big books and because they have stacks of transactional work sitting around the office to consume their time, partners with small books tend to do more of the work themselves to stay busy. This, in turn, teaches their clients that a \$350 tax return is work worthy of a

partner's undivided attention. Besides the low realization we already touched on, this situation creates a transition nightmare. When the client, after being served by a prominent partner for 15 years, gets handed down to a manager as their main point of contact, the client feels slighted and unappreciated. Keeping this account is not as much about the charisma of the new person handling it as it is about the unrealistic expectation of service set by the previous partner.

Finally, we want to talk about value. First, consider that often the only difference between a \$500,000 and a \$5 million firm is about 8 partners (each doing about \$500,000–\$700,000 of work). So, when a partner maxes out at approximately a \$500,000–\$700,000 book size, for all the reasons previously discussed, little leverage of firm value is generated. Although the market is still OK today for small firms, in our opinion, it will get worse soon. Everyone is becoming increasingly aware that a firm built around leverage is more valuable (having the partner manage the client with managers and staff doing the work). Fewer and fewer firms will want to buy books of business that require partners to work 3,000 hours to bill \$600,000. Fewer and fewer firms will want to buy client bases that are loyal to just one individual, and fewer and fewer firms will want to buy operations in which staffing the work at the right level will run off the clients because of unrealistic service expectations.

Small book partners, it is time to grab the brass ring by moving beyond your comfort zone. It is time to realize that you need to grow your capacity to handle clients at the rate of about \$150,000 per year for the next five years to catch up to where you need to be. It's time to start leveraging your work, run a more profitable book of business, work fewer hours, and take more money home—all the while increasing the value of your firm.

Negative Contributions of the Large Book Partners

Now we will pick on the large book partners. Large book partners are able to manage more work because they tend to delegate the project management. Therefore, they spend far less time working on the projects, which frees up more time to work on developing client relationships. In turn, this additional time spent developing client relationships expands the book gap even further because this extended client focus generates new business (both through additional services and a higher number of referrals). In our opinion, managing the client is the most critical role and responsibility of any partner.

With this as a backdrop, large book partners tend to have a better philosophical approach about where they should spend their time. However, this is where the good news often ends.

The reason why most large book partners can pull off this ability to delegate is because they are the senior partners of the firm. Rather than approach this delegation correctly by having managers and staff perform the work, they tend to use younger or junior partners to manage their projects. Although this might not sound that bad, it is one of the most stifling and damaging acts that affects the long-term success of the firm.

As we previously said, anyone can delegate work to another partner. Unfortunately, this problem typically starts with a misaligned compensation plan. Because so many firms heavily pay partners for the size of the book managed, partners are not inclined to ever pass client responsibility to other partners and managers. In other words, partners hoard client management, and this sets in motion a number of damaging results.

The first is that hoarding partners have account responsibility for more clients than time allows them to manage. Therefore, many clients are underserved. This not only stifles growth (because clients willing to pay for additional services are ignored), but it puts clients at risk (underserved clients will eventually look for help from other professionals).

Second, because senior partners often are able to manage large books of business by passing the project management to younger partners, the younger partners are relegated to the role of manager on those clients. Therefore, instead of doing partner-level work themselves, they spend a great deal of their time doing the detail work instead of passing it down to managers and staff. This move destroys leverage, undermines engagement realization and profitability, as well as demotes partners to managers when those partners serve clients.

Third, because younger partners don't have a large enough book to fully occupy their time, from a client management standpoint, and because the firm won't take steps to shift clients around to close the gap in book size, younger partners tend to enhance their personal compensation by performing the detail work on their own book of business, as well. Once again, this move negatively affects the firm.

Fourth, because the younger partners do too much detail work themselves, an entire layer of management is never developed below them. This creates a very large gap in talent between partners and all other staff (producing the upside down staffing pyramid we previously discussed). Long-term, this approach cripples the firm.

As if all of this was not bad enough, because the younger partners are so busy acting like managers due to the senior partners hoarding client management (with the trickle down of managers acting like staff, staff acting like interns, and so on), the younger partners get criticized for not developing a larger book, even though a great deal of their time has been tied up by the senior partners inappropriately delegating work to them in the first place.

So, there you have it, and it is ugly. Although small book partners are not as profitable as they should be and they typically act more like managers than partners, it is the large book partners who are often the reason this system starts to fail in the first place. Your bottom line will improve almost instantly as soon as the partners in your firm understand that all clients are the firm's clients, not a partner's. Shift clients around to close the book size gap and start requiring all partners to fill their time by acting like partners.

Client Acceptance and Retention

With the abundance of opportunities available to CPA firms today and the continuing increases in costs of staff salaries, CPA firm owners need to take a hard look at whom they're doing work for and whether the profitability and stress associated with certain clients are really worth continuing the relationship. Also, consider all of those requests for proposals you get asking for low bids on work that you can't figure out how to staff due to your present workforce shortage. What kind of sense does it make to accept more work at less-than-standard rates when you don't even have enough staff to do the work you already have? What about the desirability of a potential client, even those who aren't looking for the low bid? What have you done to be sure that they'll really be a fit with your firm? Having appropriate, standardized due diligence processes in place to screen potential clients will help answer these questions.

As you've been reading through this material, you've probably been asking yourself how you're going to have time to learn to be a better manager, train your people more, establish marketing plans, and standardize all of your procedures. Part of what you can do is evaluate and rank all of your clients, raise your rates, or run off the undesirable clients at the bottom of the list. We use an "A," "B," "C," and "D" scheme to classify clients, and we have included it as appendix B, "Sample Client Evaluation," as a tool here for you to review.

As a quick summary, "A" clients are the absolute top clients. They never squabble about fees, they appreciate your relationship with them, they value you as a trusted advisor, and they actively promote you to their friends and colleagues. "B" clients are "A" clients who can benefit from more of your services than you presently are providing, and they are therefore likely to be a little underserved. "C" clients are not bad clients; they just don't have much opportunity over and above the tax return or bookkeeping that you are now providing. "D" clients are those who should be an "A," "B," or "C" client, but you have some problems with them.

In every practice we've seen, 10 percent to 30 percent of the clients provide 80 percent to 90 percent of the firm's volume and profit. These are your "A" and high "B" clients. By focusing more of your precious time on them, you can build even stronger relationships that benefit them and your firm. Get rid of the bad clients, and you'll have time to devote to the other activities necessary for cleaning up your operations. In fact, the first step in cleaning up operations should be to evaluate, rank, and upgrade your clients, leading to increased capacity within your firm. This is something every firm should do, whether the owners are thinking about walking away and turning out the lights, selling, or merging in either direction. At the worst case, you can work a little less and make the same or even more money than you have been earning. At the best case, you open up significant upside potential for the long run. Let's say you have a \$400,000 practice, and you raise your fees in the following manner with these consequences:

- "A" clients = \$100,000. You raise your fees 10 percent, and this runs off 10 percent of your clients, with net fees from this group being \$99,000 next year.
- "B" clients = \$100,000. You raise your fees 10 percent, and this runs off 10 percent of your clients, with net fees from this group being \$99,000 next year.
- "C" clients = \$100,000. You raise your fees 25 percent, and this runs off 15 percent of your clients, with net fees from this group being \$106,250 next year.
- "D" clients = \$100,000. You raise your fees 75 percent, and this runs off 50 percent of your clients, with net fees from this group being \$87,500 next year.

The net result would be a reduction of approximately 25 percent of the time required to do the work, with a total reduction in fees of a little more than \$8,000. Keep in mind that this scenario assumes the rate increase will run off some "A" and "B" clients, which usually is somewhat rare. Create your own math scenario. It just doesn't pay, either in time or money, to do work at discounted rates for marginal clients. Our personal experience is that you will not run off nearly as many clients as you think you will. As an offset, if you want to grow your practice, your freed-up time will allow you to find much better work than you

lost. As a side benefit for the future, the effort you just made raised the value of your firm. We have included appendix C, “Closing Your Door to Bad Clients,” as a practical resource to help guide classifying A, B, C and D clients.

Improving the Bottom Line

Whether you are thinking about retiring, selling, merging, or just working for a long period of time without regard to an exit strategy, you should take steps now, if possible, to better secure your personal future, as well as that of your firm. This urgency significantly rises in importance for those who wish to retire within the next four or five years. To be able to develop the most workable and beneficial retirement scenario, CPA firm owners need to be creating multiple options for their succession rather than just relying on one. All of those options are enhanced by improving your bottom line, so we are summarizing a number of points we have made throughout this chapter as steps you should consider taking. They are as follows:

- Agree as a group of owners on an overall direction and hold one another accountable for moving in that direction by
 - being clear about where you want to take the practice over the long-term (develop a shared three year vision for the business).
 - determining what you should stop and start doing to move in that long-term direction. What you decide to stop doing is often more important than what you decide to start doing.
 - identifying what strategies you need to implement to achieve your long-term goals.
 - spending money and time implementing strategies to keep up with changes and allowing flexibility to take advantage of strategic opportunities that present themselves.
- Create and monitor performance metrics to measure whether your firm is changing according to plan.
- Either salvage or run off the bottom 10 percent to 20 percent of your clients.
- Spend more partner time managing relationships (balance book size, implement clear roles and responsibilities, provide management oversight of these activities, and so on).
- Implement some standardized ways of doing things, with accountability (which comes with rewards or punishments) for following firm standards.
- Beef up client acceptance procedures and make sure you are selling work at fair rates (rather than giving it away at self-imposed discounts). New projects from existing clients should pass through a similar set of procedures.
- Continually look at the economics of your business to identify your most and least profitable clients, and deal with them accordingly.
- Find ways to better service clients by making a cultural commitment to live up to our profession’s mantra of being our clients’ most trusted adviser.
- Work actively to recruit, develop, and retain the next generation of professionals.

- Instill a culture to train, train, and then train some more, followed by pushing everyone to delegate, delegate, and then delegate some more. Replace the phrase “I can do it faster myself” with “My job is to train others so we can create leverage.” This is the fastest way to reverse the upside down pyramid.
- Take the time required to retool everyone on a routine basis in the technical requirements of their jobs.
- Raise rates. To be able to take the time and spend the money required for continual learning and development, especially with the changing requirement to build your own talent internally, CPA firms need to be charging sufficiently high rates for their work.
- Be intolerant of marginal employees. Too many firms put too much stock in having a body present rather than understanding the negative impact marginal performers have on the people “pulling the wagon.”
- Take the time to learn a few new management skills that will create more capacity.
- Delegate manager-level work to managers (work the partners are often doing) to free up time that can be spent doing higher-level advisory work that generates better revenue and bottom lines.
- Employ technology everywhere possible to leverage everyone’s skills, as well as add efficiencies.
- Be willing to make yourself uncomfortable by dealing with changes required now to optimize future success.
- Begin now to prepare the firm for succession, regardless of your exit strategy.

You’ll find that you can benefit from running your business more like a business, with aggressive attention to implementation of agreed-upon plans. Some of these initiatives will require some investment, but if managed properly, the investment should pay off with a very high return on investment.

Appendix A

Defining Protocol For Implementing Performance Standards

EXISTING CUSTOMERS

Critical Success Factor: Courting and Educating

Key Performance Indicators

1. Percentage of meeting with business customers to go over financial statement, executive summary, tax return, or other deliverable
2. Number of meetings with customers initiated by us that do not involve a deliverable (that is, an "A" list)
3. Number of ideas provided to our customers

Implementation Protocol

1. Meetings to review deliverable
 - a. TIC should discuss with PIC who should set up meeting.
 - b. When applicable, TIC should participate in meeting to provide training opportunity for TIC and show customer our resources.
 - c. To track that a meeting has occurred, we have set up billing code (602—Meet to Review Financial Statements). This time code should be used to indicate that the meeting has occurred for any deliverable, not just financial statements.
 - d. The meeting should provide an opportunity to educate the customer about their business.
2. "A" list meetings
 - a. The "A" list will be updated, reflecting desired month for contact.
 - b. The list will be reviewed at monthly management meeting to determine appointments needed for the subsequent month.
 - c. The calendar month will be color-coded green by the TIC or PIC after the meeting occurs.
 - d. To track that a meeting has occurred, we have set up billing code (603—Meeting with As). Please use this time code to indicate that a meeting occurred.
 - e. Highlights of the "A" meetings will be shared at the weekly Monday meeting.
3. Ideas provided to customer
 - a. Ideas can include the following:
 - i. Business solutions
 - ii. Tax strategies
 - iii. Management recommendations

- b. Ideas communicated can be done orally or in writing.
 - i. An idea page should be established in CaseWare so anyone can access what has been communicated. This also will help bridge us to a paperless environment.

Critical Success Factor: Taking Control of Problem and Progression

Key Performance Indicators

1. Communication of new developments to customers
2. Number of continuing professional education (CPE) hours in areas that promote additional services

Implementation Protocol

1. New developments
 - a. We will track the number of times we send out communication via letter or e-mail to our customers regarding new developments that could affect them (that is, tax alerts, business issues, and so on).
2. CPE for the future
 - a. Recognizing that the only constant is change, we must strive to look for new opportunities that move the firm forward and provide valuable services to our customers.
 - b. Selection of CPE courses should evolve around how you could benefit our customers from the knowledge that you gain.
 - c. When you enter your time into GO! Systems and code as CPE, make sure you put the course title in the comments section. This will serve as a basis for updating the KPI spreadsheet.

Critical Success Factor: Entrepreneur Spirit

Key Performance Indicators

1. Number of opportunities identified
2. Number of ideas resulting in additional work to be done by the firm

Implementation Protocol

1. Opportunities identified
 - a. In the entrepreneur spirit, each of us needs to think of our customer's business as if it were our own. Creating this mindset will help you identify opportunities that benefit our customer's business.
 - b. Ideas need to be communicated. You should discuss your thoughts with the PIC to determine the following:
 - i. The ideas to be communicated.
 - ii. Who should communicate?
 - iii. Communication can be written or oral.
 - iv. An ideas list should be maintained in CaseWare.
2. Ideas resulting in additional services
 - a. The KPI spreadsheet will need to be updated during the month that the additional work is to be performed. We are tracking our success of converting ideas into additional work.

Critical Success Factor: Prompt Completion**Key Performance Indicators**

1. Days to complete tax returns
2. Days to complete financial statements

Implementation Protocol

1. Each business tax return and financial statement job is logged into our time and billing system indicating the date information entered our office. Upon completion, the database is updated to reflect the date the job was delivered. A job completion report is shared weekly at the Monday meeting with all team members. Once a month, the report recaps the average number of days it took to complete tax returns and financial statements.
2. A report indicating the number of days each job has been in-house for each team member is distributed weekly at the Monday meeting and reviewed. This information will increase awareness of jobs that are getting near the expected turnaround time.

POTENTIAL CUSTOMERS**Critical Success Factor: Business is Great and We are Looking for More****Key Performance Indicators**

1. Educating team on communicating this message

Implementation Protocol

1. Educating team
 - Include as part of our Monday meetings an opportunity to discuss what our consistent message should be.
 - Team members will share their experience of the message they recently communicated.
 - Discuss the reaction they received from the individual.
 - Discuss what they would do different.
 - Track education being done in the KPI spreadsheet.
 - Provide in-house CPE on best practices in communication at least three times a year.

Critical Success Factor: Community Involvement**Key Performance Indicators**

1. Average number of hours per person

Implementation Protocol

1. Hours per person
 - a. Your involvement in the community through participation in civic organizations is an important part of defining who we are as a firm.
 - b. Your time should be coded to work code 950 for time spent during business hours.

REFERRAL SOURCES

Critical Success Factor: Reputation

Key Performance Indicators

1. Provide a 60 second survey to our customers

Implementation Protocol

1. Customer survey
 - a. Would they refer our firm to another business?
 - b. Tabulate their response.

Critical Success Factor: Existing Customers

Key Performance Indicators

1. Number of times we asked customers for a referral
2. Number of referrals received from customers

Implementation Protocol

1. Asking for referral
 - a. Enter on KPI spreadsheet the number of times you asked for referrals during the month.
2. Referral received
 - a. New customer set up in GO! Systems needs to include referral source entered under the marketing section.
 - b. Track through GO! Systems referrals received.

Critical Success Factor: Exposure to Other Professionals

Key Performance Indicators

1. Number of individuals met at various functions with whom you shared our story

Implementation Protocol

1. Sharing our story
 - a. Enter on KPI spreadsheet the number of times you shared our story during the month.

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Appendix C

Closing Your Door to “Bad” Clients

By William Pirolli, CPA

“You’re fired!!!” Never has such an ominous phrase been so popular. Although now part of our popular culture, these words are still difficult to hear and, for most, even more difficult to say.

Many of us either have experienced being fired or have had to tell a staff member or associate that their services were no longer required. Some of us have even been fired by a client. However, how often have you turned the tables and actually fired a client?

With the accounting profession facing what seems to be a never ending staffing problem with no shortage of work in sight, firms of all sizes are struggling with how to render timely quality services to their clients. Too often, the reaction is to add staff and hope the problem goes away.

Perhaps a better idea is to take stock of what your firm is doing, what your priorities are, what you like to do, and what you are best at and, instead of adding staff, reduce the number of clients you serve. Shocking for sure, but isn’t it just possible that by focusing your firm’s resources on a narrower set of services, you could actually provide higher quality services, achieve more efficiency and higher profitability, and produce less stress?

The Stop, Start, and Continue Test

An easy way to take stock is to conduct a stop, start, and continue evaluation of your firm. The objective of this exercise is to seek answers to these questions: What are we doing today that we should stop doing? What are we not doing that we should start doing? What are we doing well that we should do more of? Involve the entire firm in this evaluation because staff input is critical here.

We have gone through this exercise many times in our firm. In the past, it led to decisions to stop doing payroll and write-up work, discontinue doing certified audits and nonprofit work, expand our estate and trust services, and add performance measure and investment advisory services to our practice. Of course, any time you stop providing a service, you may no longer be able to service some clients in the same way, if at all.

In these cases, we tried not to fire the client but, rather, we upgraded them to keep pace. We assisted the payroll and bookkeeping clients in developing internal recordkeeping systems, hired quality bookkeepers for them, or hired an outside payroll service. In the case of our audit practice, we converted several to reviews and the rest we contracted out to other firms, thereby allowing us to continue to service the account for tax and consulting and, at the same time, build some strong, strategic alliances with other firms. These alliances have produced many referrals for us, as well. Developing strong, strategic alliances with other firms is critical to helping you refocus your firm’s services and transitioning clients.

Client Acceptance Policies

More importantly, we learned to say “No” to this type of work in the future. By establishing strong policies related to client acceptance, we have limited the number of clients who don’t seem to fit. I fully recognize, however, that there are always exceptions. When your best client asks you to help out with

his son's small business, saying "No" may not be an option. Constant exceptions to the rule, however, create a hodgepodge of inefficiency, with the firm's only real commitment being trying to be all things to all people.

As we work hard to build our reputations and referral sources, saying "No" to a potential client is very difficult. As a profession, we also place a high premium on our partners and those wanting to become partners and their generation of new business. This seems to translate only into new clients, but in reality, most of our growth comes from our own clients' internal growth. So why shouldn't this count as new business?

Before Saying "Yes"

The next time you are tempted to say "Yes" to a new client that you shouldn't take on, keep two things in mind. First, you moved away from providing a certain service because you didn't like it or perhaps because you had so little opportunity to provide it you weren't as good at it as you are with other services. Going back puts you in the same situation you were in before.

Second, if you are a good marketer, something else that fits always seems to come along. Aren't you complaining that you have too much to do as it is? It takes much more effort to develop a new relationship than it does to expand an existing relationship. The first time you say "No" to a potentially good client, pick up the phone and take one of your existing clients to lunch and see if they need any additional services. Leverage in your database is just waiting to be discovered. Have you ever heard a fellow accountant say, "If I could get rid of most of my clients and staff and just focus on my best clients, I would be all set"? Well, what are you waiting for?

Now, let's talk about the bad clients. You know the ones. Late filers, late payers, bad recordkeepers, abusive, always needing it yesterday, and never wanting to pay for it. Most importantly, they have turned their problems into your problems and perhaps put your firm at risk. We are not talking about difficult clients. We all have them. We are talking about bad clients. In fact, if you're unsure who the bad clients are, just ask the staff or, for the most reliable information, ask the person who answers the phone. That person is the first line of defense and knows all the bad apples.

The question is why do we keep them around when we don't like them and they don't appreciate us? Please don't say that it's to keep staff busy during slow periods or that we use them for training. Let's deal with slow periods with proper staffing and rendering nonseasonal services, such as estate and investment planning, to existing clients. Training staff on bad clients will only produce frustrated staff. A bad client is just that—a bad client not worthy of your time and resources, not now and not later.

Check Your Compensation Model

So, why do we keep them? Pride; fear; stubbornness; growth for growth's sake; refusal to accept change, even change that is good for us and our firm. Perhaps your firm compensates partners based upon a gross book of business, regardless of how bad the client is, how little the firm nets, or how often the apple cart is upset. Should a partner's compensation suffer for getting rid of a bad client? Wasn't that the cause of some of the profession's recent problems? Doing the right thing was expensive to someone, so bad decisions were made. If your compensation model places a higher value on a bad client than a good decision, perhaps it's time to revisit the model.

In theory, getting rid of these clients should be easy. Write the letter and tell them you are no longer in a position to service their account. Blame it on yourself with no hard feelings. The relationship is just not right. We run businesses and sometimes we lose sight of that. We are not bound to represent people we don't like or who cause general chaos all the time. Why do we make it harder than it needs to be? For all of the reasons previously stated, once they're on board, we resist letting anyone go. We view firing a client as a failure instead of a successful commitment to our firm's strategic growth. "Suck it up and deal with it," is the typical firm motto. "We can't afford to lose the revenue." In today's climate, you can't afford to keep the revenue.

So, what is the incentive for firing a client? Besides the great feeling of empowerment it will give you, your staff will appreciate it, and it will be a great morale booster. In addition, if this pruning is done as part of a long-term plan to focus your practice on a selected mix of services and clients, then it will produce a smoother running and less stressful office.

Is Raising Prices a Deterrent?

Another school of thought exists for making bad clients go away. Many practitioners say that the way to drive them out is to raise their fees so high that either they will leave or continuing to provide them services will become worth the aggravation. This is certainly worth a try, but I have two thoughts here. One is that, as a profession, we are terrible at actually doing this. We all have stories about how we have, on occasion, gone this route. For the most part, however, the “premium” we are willing to charge does little to change our attitude about the client. My second thought is the old restaurant motto, “One unhappy customer will tell 10 people about their experience.” Sure, we don’t want them as clients any more, but we also don’t want them out there saying bad things about us. If they are really bad enough to fire, however, then virtually no amount of money will make them better.

With filing season behind us, I hope you use this recovery period to evaluate your practice while it is still fresh in your mind and think about both pruning the tree to focus your practice and firing a few bad apples. Even the best of firms require ongoing maintenance. Think of it as a spring cleaning for your firm. Next week I may even write a few letters myself.

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Chapter 4



Selling Your CPA Practice

Introduction

We have a two pronged focus in the chapter. The first is to discuss the general steps you might consider regardless of whether you are interested in selling or merging your practice. This information will apply to both chapters 4 (predominantly about the sale of a practice) and chapter 5 (about merging your practice). In order to minimize duplication, we will cover the issues relative to any transaction first. The remainder of this chapter will then focus on what you should consider if you are planning to sell your practice to another firm (and not transitioning it internally to your partners or merging it with another firm). In other words, when we use the terms *sale* or *selling*, we are assuming that the owner(s) of the firm being sold will not stay on with the acquiring firm as owner(s) once the transfer agreement is executed. Chapter 5 covers issues specific to mergers of practices, both upstream and downstream.

When we talk about the sale of a practice in this chapter, we are only referring to an arm's length transaction between a buyer and seller, not one partner selling to another (an external sale rather than an internal sale). We will cover an internal sale in chapter 8.

As we discussed earlier in chapter 3 of this text, the first thing you need to do is make sure you have a plan to clean up your operations and that you are actively working that plan.

The next step focuses on addressing specific issues, or nuances of issues previously covered, that relate to the sale of your practice.

To facilitate your preparation for a sale, we have created the transitioning an accounting practice (TAP) checklist, which is located at the end of this chapter as appendix A, “Using the Transfer of an Accounting Practice Checklist.” This checklist covers critical areas that firms should consider when they are about to go through or undertake selling, an internal buyout, acquiring, or merging. Because this is an all-in-one checklist, look in the “Sale” column to see which factors apply to a sale, for example. In addition, look for any high-lighted boxes to note which of those issues or processes should have the greatest impact on the type of transaction you are contemplating for your practice, as well as the price you are offered for it.

Just to get this out of the way, we know the first question on most CPAs’ minds at this stage, whether they are considering a merger or a sale is “What can I get for my firm?” Because the last chapter in this book, chapter 9, is dedicated to this topic, for now, let’s just say that the sales price of your firm is likely to be between zero and \$1 for your revenues, a multiple of your profits, some amount to obtain your people, or any combination of these.

Once sale price (sale) or equity interest (merger) is taken off the table, the next question is “What are some important issues or nuances that affect value?” Our answer is “All of the things you have been putting off addressing and the things you don’t want to spend money on implementing.” Firm owners kid themselves every day regarding the value they are building because of haphazard management practices. For example, what firms have been buying historically (or looking to acquire through mergers) are the client list and revenue stream of other firms. However, today, what firms are really looking for is a combination of people to do the work, as well as the revenue stream, with revenue stream diminishing in importance.

In the case of either a sale or merger, when owners retire or sell their practice, or merge into a larger practice, to make the acquisition of that practice viable, the acquiring firm needs to not only retain the profitable clients but also find someone to do the work. For these reasons, today, smaller practices are still occasionally earning seemingly higher sales prices (more on that later). Why? Because integrating a few profitable clients using the existing staff of the buyer may be feasible. However, the bigger the firm, the more the acquirer shifts his or her focus toward the combination of the people, the revenue, and the profits simply because the buyer will need the additional capacity and funding to make the deal work.

In the end, the seller almost always only gets paid for clients the purchaser retains. So, the first thing the buyer does to maximize the value of his or her purchase and minimize the amount owed the seller, is to run off any clients who won’t pay standard rates; are one-off unique engagements; or are problem clients, such as collection problems. Similarly, the equity interest in the new firm that the owner of a firm merging upstream will get will reflect client retention as well. So, all of those clients who you (the seller) continue to service that would fall into this “marginal” client category are likely of no value for an exit strategy.

The point is that you want to start running your firm in a way that, at a minimum, emulates your potential acquirer's operating standards. This means that you want to start charging at least the same rates that your potential acquisition candidates charge, that you begin following a similar or more stringent client acceptance policy, that your write-offs are in line or less than theirs, and so on. This is just one of many nuances that we will cover in this chapter. How you address the issues important to the sale of your practice will have a great deal to do with how happy you are with the final outcome. Enjoy the discovery!

Steps in Selling or Merging a Practice

Hopefully, your desired timing for the merger or outside sale of your practice will leave you with enough time to improve the practice through some of the techniques we covered in chapter 3. In any event, once you've decided to merge or sell your practice and are ready to begin the process, you'll need to take several steps. These steps usually involve the following:

- Identify likely candidates with whom to merge or to buy your practice.
- Contact potential candidates and discuss the potential merger or sale of your firm briefly and conceptually with them.
- For prospects buyers interested in pursuing discussions
 - prepare a nondisclosure agreement for prospects to sign.
 - provide prospective candidates with a high level summary of practice statistics, such as the performance metrics we covered in the previous chapter. For mergers, obtain similar information from the merger candidate as well.
- If further discussions are warranted at this point, provide the potential merger candidate or buyer with more detailed information on client groupings and your personnel. For mergers, obtain similar information from the merger candidate as well.
- Continue discussions through to closure.
- Stay focused on keeping the matter confidential so that it doesn't get out to your staff or into the community until you're ready to announce a deal.
- Announce the deal to your employees, clients, and referral sources. This is an especially important step requiring careful consideration if your firm is being sold or merging upstream into another firm.
- If you are selling your practice, be available to help with transitioning the practice and the clients to the new firm.
- If you are merging your practice, actively participate in merger integration between the two practices.

Identify Likely Candidates with Whom to Merge Or to Buy Your Practice

This first step requires you to think about which firms would be a good fit for your clients and employees. The better the fit between your firm and the prospective merger partner or buyer, the

- more likely it will be viewed favorably by the client base of your firm.
- easier it will be for your employees to embrace the change and want to stay with the new firm.
- greater the chance for long-term success and profitability for both organizations.

When we talk about fit, we're talking about a variety of issues you should consider above and beyond the typical due diligence checklists you can use to work through the details of a deal. It's really about compatibility of the business models, staffing, client base, fee structure, practice style, and firm culture. It requires you to be able to answer questions, such as the following:

- How well will my clients and people get along with this new firm?
- How do we, and will we, do things around here?

If you are looking at selling your practice, we realize that you may be thinking, "What the heck, I'm leaving after the sale anyway—it's not my problem." However, it usually will be a problem for you if you engineer a practice transfer that marginally works. This disconnect typically has a very adverse affect on your buyout settlement—no ifs, ands, or buts about it. In a similar vein, if you are looking to merge and you make a hasty choice that turns out to be a mistake, it can cost you dearly. That's why you need to go beyond the typical due diligence checklist to be as sure as you can that it's the right choice for you. We recommend that you consider the compatibility of the practices in several broad areas, such as the following:

- General cultural match
- Client bases and services offered
- Performance management and pay systems
- Firm ownership and governance models
- Business processes and practices
- Succession management practices
- Strategic perspective
- Owners' styles, and relationships

You may be asking, "How am I supposed to know that kind of information about these firms?" You probably already know enough to make an initial judgment about the most likely contenders in the marketplace, just from having competed against them and from your contacts with them at professional functions. As you discuss the deal with them, you'll get a better feel for the fit between your practice and theirs. We're not after surgical precision here—what we're looking for is a rough-cut idea of how compatible your practice might be with the acquiring firm's way of doing business. You can use the TAP checklist (see appendix A) as a guide and scorecard as you consider firms in light of the following information. Because determining fit is applicable to both sales and merger transactions, we will cover it here for both types of transactions.

General Cultural Match

Culture is part of "how we do things around here." It's derived from explicit behaviors and physical trappings, as well as assumptions that are often unstated. You can begin to assess someone's cultural fit with your culture by looking at the following obvious physical characteristics of the practices:

- *Locations.* In what part of the community, what type of office space (class “A,” the upscale buildings, or class “C,” a more modest physical presence), and so on?
- *Office layout and design.* Sizes of offices, use of cubicles versus private offices, and so on.
- *Furnishings and decorations.* Again, there could be a wide spread between the tangible trappings of the firms, from low end and hopefully functional to high end, upscale pieces.
- *Technology.* Does the firm use technology to support various functions or is it so technologically integrated that everyone has to be computer savvy just to be able to work there?

When we talk about behaviors and underlying assumptions, we’re referring to yet more factors that you should be able to observe or at least infer from your observations. Things to consider in comparing cultures include the following:

- *Level of formality.* When you call the other firm’s office, do they refer to the owners as Mr. or Mrs. or by their first names? How are you addressed at your office? When you see the owners and any of their staff out and about during the work week, do they seem to dress as you and your people do, or does their look typify “pinstripe” while yours screams “business casual?”
- *Displays of affluence.* Do you and your key people all drive European sports cars (for example, Porsches, BMWs, sporty Mercedes models, and so on), but the acquiring firm owners drive conservative American cars? Do they all wear Rolex or Patek Philippe watches, but you and your people wear Timex and Citizen watches? Here again, these things may be indicative of different cultures (and, likely, billing rates).
- *“Old school” or more up-to-date view of work-life balance.* We covered this in chapter 3. Suffice it to say that if yours is one of the increasing number of firms that expects people to have something approaching a “normal” life outside of work with limited overtime requirements, the transfer of your practice to, or merger with, a firm where staff are averaging 2,600 hours or more per year will not bode well for retention of your key people by the acquiring firm.
- *Always serious versus relaxed and fun.* Is your office environment one of work hard and play hard, or is everyone serious at work? Does your office tend to have firm outings with people socializing after work hours versus a firm that everyone considers just a place to work?

None of these comments are judgmental. It doesn’t matter which of these best describe your firm. They all work, and we know examples of all of them, both successful and marginal, in each version of each category. So, this is not about right or wrong but, rather, about finding *similar* cultures. One thing to understand is that many of your clients are far more connected to a familiar face than you may think. So, in a sale, if one or more of your people are going to be at the new firm, then that will make moving with those familiar faces a lot easier. If they don’t know anyone in the new firm, regardless of their level, you have an added hurdle to overcome to maximize the value of your sale. The same can be true for some mergers where not all key firm personnel end up going with the new organization.

Client Bases and Services Offered

Rules of thumb in this area deal with compatibility about the industries served, size and nature of clients, offerings provided, service policies and practices, rates, and locations:

- *Industries served.* Do you service clients in industries in which the acquiring firm has expertise? If not, how can you expect an optimal transition and retention of those clients by the new firm in a sale? In a merger, how will this niche fit into the overall strategy and operations of the new firm after the merger, and can you expect the technical support you need for retention of those clients by the other firm? For example, if you specialize in auto dealers or construction contractors, you stand to strike a better deal with a firm that shares that specialty and is known in the marketplace for it, as well.
- *Nature of clients served.* Do both firms have client bases similar in size of clients, sophistication of clients, and nature of industries? Does one firm service more sophisticated organizations that have CPAs in roles as CFOs, but the other has more clients with less well-trained bookkeepers in key financial compliance roles?
- *Service offerings.* What about services offered? Does one firm offer mostly tax, some compilation, and business advisory services, but the other offers mostly audits and some reviews, with significant transactional tax planning? This could be viewed as synergy and a good thing, but this diversity also could be a huge disconnect because the firm could struggle trying to maintain the skills and expertise to deliver these services. Additionally, if you have truly engaged your clients as their most trusted business advisor and the acquiring firm partners just want to do their tax and audit work, there will be client attrition, and it will reduce your net take from a sale of the practice, and it may not bode well for you in a merger either.
- *Service policies and procedures.* Does one firm see itself as the “Tiffany” of local firms, charging high prices for apparent value added through its high level of service and service quality, but the other provides essentially a similar quality of technical work at a no-frills price with services that reflect the pricing?
- *Charge rates and fee structure.* The bottom line issue here is how closely aligned are the fee structures of the two firms? Is one charging clients significantly less than the other for comparable work? In particular, if your effective rates (chargeable time less write-downs divided by total hours) you are charging are less than those of the other firm in this transaction, you will have problems. A big enough spread here can negate a deal. A lesser spread may allow a deal to take place, but as the clients are billed the higher rates of the new firm, some of the clients are likely to go elsewhere for future assistance (especially “C” level clients). As your transitioned clients leave the new firm, the odds are very high that the dollars you thought you would be collecting from the sale of your practice will be diminishing. Similarly, if you merge and your clients drop off dramatically, it will affect the deal you made in the merger agreement.
- *Geographic locations and related differences.* Different parts of the country, state, or region have different subcultures and, potentially, unique economic conditions that

can create some interesting issues for you to consider. We've seen significant differences in the way people do business, cost of living, communication styles, service sophistication, and more. The point is that just because two offices are within 50 miles of one another, don't assume that client sharing and service synergy will be a slam dunk because there could be dramatically different expectations for the kind of relationship, formality, and cost of service each community is looking to experience, not to mention staffing availability and labor costs.

Performance Management and Pay Systems

What we are talking about here is what gets measured and monitored for the purposes of compensation, and how do people get paid at the two firms? Is one firm more focused on the individual productivity of partners, but the other is focused on cross-selling and paying partners to implement strategy? What do partners' perks include at each firm? What about staff performance management, pay, and benefits? Do the two firms have similar expectations for staff and similar compensation scales and ranges for similar positions? Is personal time off, vacation, sick leave, and so on handled similarly? Don't forget about performance evaluations and career counseling activities. If you're looking at a merger, what are the two firms doing about recruiting and constantly building a pipeline of talent? How much effort is going into helping staff with their professional development and career paths? Does either firm even conduct these activities, and if so, how frequently and effectively?

Firm Ownership and Governance Models

This runs the gamut from understanding what each firm requires for someone to be admitted as a partner to how current equity ownership is shared to overall governance. Does either firm have formal policies governing admission to partnership? Would any of the existing personnel be considered as a partner candidate in the new firm (there may have been commitments made to key personnel by the owner years before selling or merging the firm)? How is ownership spread out among current partners? How are key issues decided at voting time—by equity ownership percentage; one partner, one vote; majority vote; or unanimous vote, or some other variation? Do either of the firms have standard operating procedures in place that discuss these issues, roles of partners, and so on? What form of governance and management is used—board with strong managing partner or CEO, the key power rests in the executive committee, consensus management by all partners, or one of many other variations?

What about ownership agreements? Is there one (and only one) signed agreement in place? Yes, you read that right. We've seen firms where there were six or more versions of ownership agreements, with each agreement signed by a few owners but no agreement being signed by all owners. Besides this level of governance chaos being a recipe for disaster, it's also a potential sign of lack of agreement on, and shared commitment to, the buyout process. In other words, you might be selling to, or merging in with, one firm, but in a matter of months or one year, it could break into multiple firms. When splits occur, a selling firm that is still owed money for the purchase, or recently merged-in firm, usually will suffer from this kind of change.

Business Processes and Practices

A very basic consideration is the nature, extent, and quality of communication within each of the firms. What formal and informal communication processes are in place at each firm? What about other policies and procedures (for example, standard operating procedures)? How does each firm deal with practice development and client acceptance, billing and collection, and so on? What about staffing and leverage of partners' time? What are the organizational structures at each firm, and is one or both top heavy? Does one firm use more lower-level staff to carry out its work, but at the other, even smaller clients have become accustomed to having a partner's personal attention? To what extent does either firm use functional specialization to carry out client projects (for example, requiring all tax issues and work to be reviewed by the tax department rather than just by the partner in charge of the client relationship)?

How standardized are the procedures at each firm? Do owners each run their area of the business differently, or do they follow standard procedures for documenting work, filing working papers, reviewing the work, and so on? If neither one of the firms have much in the way of standardized procedures, how will you determine which to use? If your practice is fairly standardized in its approach and the prospective merger candidate or buyer is not, what might that combination do to undermine what you have already built? Also, in a merger, what are you putting in place to assure that the new partners will comply with your standard operating procedures?

What about work-life balance? We are not asking what the party line is on this because that most often represents the marketing spin sold to new hires. The answer to this question can be quickly seen in the work hours and work flexibility options. Do staff and partners regularly work in excess of 50 hours per week? Is it common for people to work on Saturdays and even Sundays? If overtime is normal, is it just during tax season, or does it occur at numerous times a year? Can people opt to just work a 40-hour schedule, fewer than 40 hours per week, and so on and still be respected? This really comes down to a firm's commitment to creating capacity. In other words, does the firm try to operate at 100 percent or more of capacity and, therefore, constantly require people to work overtime to handle the overload? Or does the firm try to operate at, let's say, 85 percent capacity, which generates some overtime work, but for every week of overtime, staff is likely to have an offsetting week that requires fewer than 40 hours, as well? These can all make a difference in mergers. They can also impact the ultimate retention of your people and therefore some of your clients by any buyer, and that will have bottom line impact to you as a seller.

Succession Management Practices

If you're transferring your practice to another firm for long-term security and protection of your ultimate buyout, consider the long-term viability of the firms you are looking at as acquirers. What is the acquiring firm doing about succession management? What do the pending retirements look like for the senior owners? How many will be retiring over the next few years and at what cost to the firm? How much ownership percentage in the acquiring firm will be changing hands, and who will end up with what relative ownership percentages there? What about written agreements that clearly specify what these senior owners will get and under what terms and requirements?

What's the likelihood that the acquiring firm will end up being sold or merged upstream itself? Recognize that when significant ownership changes occur in CPA firms, often, so does their culture and internal organization. So, the person you worked closely with to finalize the sale or merger may not be there in two years, and you could wind up dealing with someone else who was not a party to the personal unwritten commitments each side made to the other. What about one sole proprietor selling to another when the buyer is close to retirement him or herself? What happens when the buyer abruptly decides to retire (because of health or an epiphany that the time has come) before the seller has been paid in full? As you can see, the succession practices and planning of the buying firm are important for the seller to understand.

Strategic Perspective

Strategic perspective refers to the role that strategy plays, if at all, in the management of each firm. It also refers to the general strategy being pursued at each firm and the relative compatibility between the two strategies. As such, this typically is more important for mergers than for sales transactions.

The first question to consider is whether either of the firms has a truly shared direction or vision that explains what either practice will look like in three to five years. In spite of the general discussion in the popular business press about strategy, we still find a great number of firms that don't have a unifying strategic direction shared by all the owners. If you currently run your firm with any sort of long-term strategy in mind, beware of joining up with a firm that doesn't operate this way. Instead of having some core philosophy and mutually agreed-upon targets for the future, you will have added partners who don't operate around strategy, and the ensuing chaos will feel like you have entered the twilight zone—a place where every idea looks like an equal opportunity. Firms that don't respect and follow strategy often create a business environment where decision making is driven by the anxiety of the day, disconnects between various operating activities are common, and accountability is probably nonexistent.

If the owners of the other firm do not operate from a strategy, although they may tell you how excited they are about the fact that you follow this process, be wary. They may even tell you that they have tried to utilize this kind of process but never found it valuable. Don't just be wary about this—turn and run. The likely reason they have tried this process and it failed is because they paid it lip service and were never willing to be held accountable for doing what was necessary to bring their vision to fruition. If there is one key to the success of a merger, it is two firms understanding that accountability for actions is not a luxury but a fundamental, foundation principle. Partners who won't hold themselves accountable are not a good fit with partners who will. If you have an excellent, timely partner culling process, then you have the luxury of quick damage control for mismatched mergers. If you don't, your next merger could put a successful firm trying to enhance its position in the marketplace into a situation in which it is fighting for its existence.

What if both firms have developed some sort of mission statement, core values, and long-term direction or strategy? What are they? Does anyone pay attention to them? Do they matter when it comes to partner compensation? How compatible do they appear to

be? For example, if one strategy is to grow through assurance service offerings and the other firm has a strategy to grow through a combination of traditional services enhanced by becoming better trusted advisers to their clients, you could be headed down the tracks to a big train wreck. Take time to really explore this area in your initial discussions.

Owners' Styles, Goals, and Relationships

If you are considering a merger, consider how the owners in each firm relate to one another. Are they very businesslike and formal in their dealings with one another, extremely informal, or somewhere in between? How much respect do they show for each other in casual interactions? Do they speak poorly of one another behind each other's backs? What are their styles of communication and processing of information? Do they primarily use quick, sound-bite discussions or longer, drawn-out detailed analyses to process information? Do they vociferously argue their points until a true, shared decision is made, or are discussions characterized by little discussion of opposing views? What about conflict? Does it show up, and if so, on what does it center? Are they passive-aggressive, seemingly agreeing to common goals but never quite implementing them? What are their core values in action, which they demonstrate in the behaviors you've observed? What kind of people do they have working for them? Are their people mousy, back-room types or more at the other end of the scale in terms of extroversion and interaction?

This is an important area. We can't overemphasize the need to really think about the questions we've raised here. Although we are as quantitative in our orientation as the next person coming from an accounting background, we will caution you to pay attention to what you're seeing in people's behavior and pay attention to your instincts and gut. Chances are that, if you think the managing partner acts somewhat like a little Napoleon now, you'll see a full-fledged, dysfunctional version once the dating game is over.

Concluding Thoughts on Identifying Likely Candidates for a Sale or Merger

When you look at the firm you're considering selling to, or merging with, take a look at their overall stability, based not only on ages and plans of partners and succession planning they've done but also on their overall approach to business. Do they have a good, solid foundation for growth, with a good cadre of senior people? Do they invest in their people and technology? Are they adequately capitalized? (Are they overcapitalized, and if so, how and when will the partners be taking draws?) Do they have appropriate managerial leadership in place? Does it look as though they will thrive in the long run, or are there generational differences between groups of owners or other critical and unresolved issues that could rip the fabric of the firm apart? You owe it to yourself, your people, and your clients to have a good grip on the prospect's stability before you commit to anything.

What's more, compatibility issues can make a difference in how well your book of business is integrated with the buyer's. As such, they will add or subtract value from the price you ultimately realize from an outside sale of your practice, and it will impact the value and affect your share of equity in a merger. So, think about these factors when choosing likely candidates to merge with or to buy your practice. When you use these factors as a

screen, you'll quickly recognize some marginal candidates and be able to devote your time to working with better qualified candidates for your practice transfer. All too often, too much focus is spent on the money in the sale or equity stake in the merger rather than the issues we have previously covered. For example, in a sale, a purchase price of \$1.25 per \$1 of revenue could end up providing the seller far less than \$0.75 cents per \$1 of revenue due to compatibility factors alone.

In a merger, the issues we just covered will actually drive the reevaluation of the deal you made. You can rest assured that any well-run acquiring firm will build in a look-back provision, correlate expected results to the actual results achieved, and adjust the original deal accordingly. If the acquiring firm does not make this part of its merger agreement, you should ask yourself why you want to merge with a firm that doesn't think this way in the first place.

The ugly side of a merger frequently involves a firm that wants to merge because the owners want to be bailed out for the management inaction or bad decisions made over the past decade or longer. To put this into a financial scenario, the senior owners of the mergee firm likely have not been making the investments necessary to sustain their firm over the long-term because they have been taking home personal earnings in greater proportion than what the firm could afford by underinvesting in their people and infrastructure. In a strange way, these firms looking for a merging are seeking to:

- leverage the investments the other firm in the merger transaction has made that they themselves were unwilling to make.
- get top value for a firm they underdeveloped.
- enjoy a free ride on the extra money they have been siphoning off the firm for many years.

The reason this is the most common expectation is because it has worked for years. However, as we covered in chapter 2, we believe those days are soon coming to an end.

When we work with firms that are considering merging upstream and we go through the likely changes they will be required to make, what they often find is one of two basic scenarios. In each case, the firm seeking the upstream merger is looking to the acquiring firm to force them to change and start operating more like a business. What they find is either of the following:

- If they are really serious about making this change, they typically know what they need to do and realize they have the option of making the necessary changes themselves so they will enjoy more flexibility and profitability than they would have as a merged firm. This often requires a partner or two to leave or be removed from the firm so that the remainder can make the required commitment to the new strategy and operating model.
- When they do a self-analysis of their situation, they realize that, considering their existing voting split on the approach, the political infighting going on, and the differences in personal strategies of the partners, the best thing they can do is turn their fate over to another firm's management team and let them referee things into a manageable situation.

So, we want to circle back around and say this. The discussion we started out with earlier about the attitudes, skills, abilities, teamwork, synergies, cooperation, operating processes, governance, business development, training, culture, and so on that really don't exist could exist in a merger once the mergor addresses the internal issues and accountability of the firm that is being merged upstream into the larger firm. Everyone has to come into these situations with their eyes open knowing that there will likely be some fallout from making the necessary transition. This also means that the deal should be structured in every way possible to motivate the owners of the firm being merged upstream to accelerate their compliance with the mergor firm's standards and processes.

Remember, whether it's a sale or a merger, when we are looking at compatibility, we are looking for success, not perfection; don't fall into "analysis paralysis" as you think through these factors. Just by thinking through them, you will be a long way down the road of putting together a successful transfer process.

Contact Potential Buyers and Discuss the Potential Sale

Whether you've already done your own mental screening and had some prospects in mind as possible buyers, or you've just now gone through the preceding factors, it's time to determine who you want to contact and start the process rolling. How do you go about starting this process? The following sections include some discussion points for you to consider as you take this crucial step for your sale.

Initial Contact and Discussion

The first discussion you have with prospects should probably be a brief phone call to each of the managing partners or CEOs of the firms at the top of your list. In this first phone call, you can briefly indicate that you're considering putting your firm on the block, or you're looking at an upstream or a downstream merger and ask them if they'd be interested in talking about a possible purchase of the practice. If merger is your game, it is important to clarify whether you are looking for a firm to merge into or a firm that will want to merge into yours. As you will see in chapter 5, a substantial difference exists between positioning your firm as the controlling firm or the acquired firm. Of course, you should let them know that your conversation with them is extremely confidential and that you're contacting them because you feel they could be a good choice for your people and your clients. You also should be telling them that some other firms have expressed an interest but that you wanted to give their firm an opportunity to take a look at what you were offering (more on the notion of having multiple firms looking at the same time follows).

At this point, the prospect may ask you about the size of your business, your staffing situation, and your timing, but it's usually a pretty general question, with a general answer required. For example, if asked about the business, you might tell the prospect revenues, service split, and personnel (for example, "I have a \$600,000 book of business that's split roughly 30 percent, 50 percent, and 25 percent among assurance, tax, and consulting work. I employ a full-time secretary, three staff, and myself."). This is about all of the information necessary to start the ball rolling. If there is interest in talking further, then we need to raise the ante of confidentiality with a nondisclosure agreement.

The Rejection

It's probable that several firms you contact will not be interested in your practice, and the response you receive during, or sometime shortly after, the first call will be a polite "Thanks, but no thanks." Keep in mind that a variety of factors could lead to this result. We've already covered a list of them in the introduction of this chapter. The other firm, when thinking about your firm even at this early stage (based on its perception about you and your practice, your client mix, staff capability, and so on), just doesn't think this combination is a good fit. This could be based on where it is now, its plans for the future, and so on. It could be that it, like so many other firms around North America, is understaffed and overworked and is already struggling to keep up with its existing client demands. It simply doesn't have the energy or capacity to take on additional work, with or without some staff coming with the work. It may not have the physical office space to accommodate taking on more staff to help handle the work. It may be dealing with its own succession problems and doesn't have the partners to manage the client load of a pending retirement, so adding your clients would spark a disaster. Thus, its polite refusal may have far more to do with its lack of planning than the reality of your practice.

On the other hand, if you haven't properly positioned your firm for sale, it could be looking at the problems that might occur in such a transaction. For instance, the challenges it will encounter when taking over a superstar practice without the superstar, with some "C" level clients inappropriately expecting a top partner's attention, and with a staff roster that includes personnel who have never been developed the way they should have been. In this case, a refusal could be an absolute reflection on you and your practice.

However, it really doesn't matter. At this point, whatever you have is all you have to offer. It is what it is, and you need to take this rejection in stride and mount a concerted effort to put your business in play by contacting all of your likely candidates more or less simultaneously.

Subsequent Discussions

Many times, this initial telephone call will be all that's needed to go to the next step. The managing partner or CEO of the other firm will be interested in taking a look and will ask you for some more information to continue the conceptual discussions. We'll cover the provision of that information in a moment. In other cases, the first call will lead to breakfast, lunch, or other off-site meetings with one or more of the owners of that firm to talk briefly about the business, staff, and preliminary thoughts regarding what you might be looking for out of the deal. In both cases, you will be asked to provide more substantive information for the next round of discussions.

Conducting Simultaneous Discussions With Prospects

It is important to put the firm in play with several prospects at the same time. This is because you'll find that some acquiring firms' leaders will take a look and then have to talk with the rest of their owners before they decide to move to the next step. Other owners will go through a couple more steps up front before they give this serious consideration. Because different people have different approaches to the investigation process of buying

a firm, you have to keep multiple parties in play so that you are not caught waiting weeks to find out one buyer was just kicking your tires before you move on to the next potential buyer. Once you start this process, you likely only have a month or two before your staff or clients get word of a possible change in your status, especially in smaller communities. So you don't have the luxury of taking a linear approach to selling your practice by dealing with one firm at a time then moving on to the next. When you take this kind of linear approach, it often leads to a sequence of discussions that stretches on for too long and causes you serious problems.

Here is another issue, and it is very psychological for the seller: each time a seller gets rejected, he or she becomes more insecure about the worth of his or her practice. This is a bad situation. If you, the seller, thought every person you called would be interested in your practice, you were dreaming in the first place. We have covered a lot of reasons why your firm could be the best in the world for you, but based on compatibility or just plain timing for the other firm, your deal won't make sense. So, you need to plan on contacting five or more firms to have a chance at one having any real interest (and this ratio assumes you know these firms and have a relationship with the partners in the first place). If the firms you are contacting are more of a cold call on your part, then the ratio decreases even further in regard to finding a likely candidate. You need to have multiple firms in process simultaneously all the time. As soon as one firm falls out, add another. This way, you, the seller, will maintain a much more positive attitude, which minimizes the nonverbal communication of desperation on your part and will likely result in a better and quicker deal for you.

Also, when you let firms know that there are other possible buyers, if the deal looks like it would fit within their strategy, they will be inclined to move more quickly and negotiate a better deal with you in order to beat out the other candidates. For example, one small firm we worked with talked to a friendly competitor firm with the same industry niche at a time when that competitor had recently decided to beef up its workload in that industry. Needless to say, it was a good match for both the buyer and the seller, and the buyer moved quickly to make sure another firm did not beat it to the punch.

Timing

When should you to kick off these discussions? It all depends. For most smaller practices that experience the thrill of busy season, it makes more sense for both the buyer and seller to start these discussions four or five months before busy season or right after it. Trying to make something like this happen too close to tax season usually ends badly. An interested party may walk away, or the seller may greatly discount the practice to get the deal done before tax season.

When you consider the fact that most deals are paid out over time, rushing the front end, compromising client communications, poor handling of files, harried introductions to the new firm, underserving transitioned clients because of the chaos, and so on all point to the seller losing value, not the buyer. For this traditional, seasonal type of practice, the worst time of the year to sell your firm is from the late third quarter into the end of the calendar year. It doesn't allow most buyers time to go through their decision-making processes, plan for the increase in business and transitioning required, and consummate the deal. It has been and can be done, but it puts you, the seller, at a greater risk of a suboptimal deal.

For Prospective Buyers Interested in Pursuing Discussions

Once you've received an indication of interest from your prospects, it's time to go to the next step in disclosure and discussion with them. You'll be asked for more specific information about your practice at this stage.

Prepare a Nondisclosure Agreement for Prospective Buyers to Sign

Just as you would advise your clients who are thinking about selling a business to obtain a nondisclosure agreement before sharing critical information with possible competitors, you should do this for your business, as well. This agreement limits the prospective buyers' use of the information you will be providing to them for their evaluation of the opportunity to buy your practice. It restricts them from discussing your information with others, and it requires them to destroy or return any documents you have provided. We've seen these documents run from approximately 2 pages to more than 10 pages in length, depending on the attorneys drafting them. Use whatever your attorney advises for your situation. If you'd like to take a look at a short but practical agreement we've used, you can review a sample nondisclosure agreement in appendix B, "Sample Mutual Confidentiality Agreement" of this chapter. Once again, we want to make this clear: we are not suggesting you use this. We are suggesting that you pay your attorney to draw one up for your firm. This is simply an example of one we have used when working with our clients.

One word of warning: just because you have a signed nondisclosure agreement, that doesn't mean you are protected. You need to work through the sales process as focused as if a ticking bomb will go off if your deal isn't completed in two months. Your ability, or better put, your desire to prosecute if someone violates their nondisclosure agreement is tenuous at best. Fortunately, we work in a very ethical profession, which gives us more protection than normal, but there will be people who have signed this agreement who will talk openly about your situation. The results of this talk are (1) you will likely never know, so you will have no way to assess the damage; (2) even if you do know, unless the damage was significant and grossly negligent, getting recourse is difficult through our court system; and (3) once the news hits the street about you selling, the damage may be done as word filters back to staff and clients. Once this happens, a good chunk of the value of your practice is likely to find alternatives to staying with your firm in order to protect themselves from an unpredictable future.

Provide Prospective Buyers With a High Level Summary of Practice Statistics

To allow your prospects to begin to evaluate the desirability of buying your practice, you'll need to provide them some additional, more detailed information. The further you go in discussions with a buyer, the more detailed information they will likely ask for. However, we've seen practices with up to \$1 million in revenues trade hands with hardly any details. When these situations occur, and they are rare, they have the following common themes:

1. The buyer has never done this before, and he or she is about to make one of the biggest mistakes of his or her careers because he or she thinks all CPA firms are alike.
2. The buyer is looking for a strategic advantage he or she feels this purchase will provide, and the details of the deal are not as important as other intangible factors of which the seller is not aware.
3. The deal is so good for the buyer that he or she doesn't care what the details are, and he or she wants to lock this down before the seller realizes the real value of the offer.
4. Because most purchases are based on the buyer paying for the clients who stay with the firm, he or she might not care because he or she will just run off everyone who doesn't fit his or her client profile.

This third and fourth issues can come as a great shock to the seller because he or she assumed (which is a mistake) that the buyer was going to try to keep all of the clients. The buyer might only want 15 percent of the clients and was willing to commit to a high dollar amount compared to revenues retained. Why? Because the purchaser was planning on cherry-picking just the few prestigious or largest clients from the seller's firm and running off the rest.

The bottom line is that most of the time, when the buying CPA firm is asking a lot of questions and wanting more detailed information, that is a good thing for the seller. It means the buyer is taking the entire purchase seriously and trying to make sure the two firms are a good fit together. Consequently, the buyer wants to be sure that some economic potential is in the deal, that the integration of the clients and staff makes sense given the purchaser's overall direction, and that the nature of the practice and business model make sense. This may not require piles of paperwork for him or her to review to make a decision. So, the first tip here is to start at a higher level of summary, and gradually work your way down to as much detail as is necessary to make a favorable deal. Don't just come in and dump every detail of your business on his or her desk. Keep the conversation going, give him or her information in consumable pieces, and regularly dialogue about what information is needed next. This helps you understand who is still interested and who is likely falling out. Someone falling out of the process is not bad news; it is just reality. The sooner you know this, the sooner you can find someone else to put in the pipeline so that you are always working multiple potential purchasers.

Staff summary. Given our last decade of staffing shortages, it's no surprise that many acquiring firms are as interested, or more, in your staff as they are in your clients. Consequently, you need to provide them with a brief summary of the people in your firm who might be coming with the practice. List the staff, charge rates, pay rates, their education, experience in public accounting, and other relevant information. It doesn't have to be a full-blown resume on each person or even what we refer to as a *summary resume*. A simple chart or table will provide enough information to create some discussion. It is meant to give them an overview of what type of people will be in play with the sale (a sample format is attached as appendix C, "Sample Staff Listing Grid").

Practice summary. Buyers want to know the size of the business, and they need to understand the relative profitability of what they're possibly buying. They'll be looking at

total production and net revenues (production net of write-downs) in order to estimate their costs to service your book and determine what's in it for them. In some cases, they will only be interested in part of the practice. In other instances, they'll be interested in the whole thing. Obviously, our advice is to sell the whole practice and not parcel out clients to different buyers. It should be an all-or-nothing approach, assuming your firm is a good fit to theirs (even though we know that all can become nothing). When someone buys your entire practice, it is up to you, the seller, to make sure the buyer is planning to try to service all of the clients. Sometimes, firms buy an entire practice with a plan to only keep a niche out of it. Make sure you do your homework to protect yourself. Usually, when a firm looks at another firm to acquire a niche, it's considering a merger rather than a purchase. We'll cover that in chapter 5.

The reason you would prefer to sell to only one firm is because of the headaches involved in this process, from delivering records to providing transition assistance, to various communications you will need to make over time regarding clients, to understanding the quirks of the players in the firm, to being paid. It's no different than buying a home entertainment center from one company versus buying a bunch of components from a number of vendors and putting them all together. Life is just easier when you only have to coordinate with one group to manage such an important and potentially unpredictable transaction.

Having said all of that, it may be necessary and possible for you to sell your firm to multiple buyers. In a recent client situation, the seller found an industry niche firm to pick up all the audits, reviews, and related tax work that went with them. The seller then sold the nonattest, compilation, and related tax book of business to another practitioner. In this case, the seller found two buyers, each of whom posed a pretty good fit with the portions of the book they bought.

So, back to our topic at hand. Practice statistics that you will likely need to get the ball rolling would include the gross production by category of work (audits, reviews, tax, and so on) and the net amount billed or realized by category. It's also helpful to provide a listing of major client groups and approximate annual fees for each of them. What we mean here is that you summarize the aggregate annual revenues to you from each group of related clients. For example, if you do work for a family that has four brothers, each of their personal returns would be included in the client grouping summary, together with all fees associated with their various entities' tax and accounting work. This gives the buyer a better idea of the nature of the work you're doing. We recommend omitting the actual client names from the group listing at this stage of the discussion. Most of this information should be easily summarized from whatever time and billing system you are using. In appendix D, "Sample Practice Summary for a Firm That is Being Sold," we included a sample of an information summary used for a sale of a small practice.

If Further Discussions Are Warranted at This Point, Provide More Detail

Assuming that everyone is still gung-ho (after the information previously discussed has been reviewed) and wants to take the discussions to the next level, you will likely be asked for more detail on staff, clients, services, and revenues. For staff, you may need to do a brief

summary resume for each that embellishes the information from the table you provided earlier. However, for smaller practices, the missing information often is filled in through personal conversations between the buyer and seller.

You may be asked to provide more information on the client groupings you provided during the first pass such as the summary we provided as an example in appendix D. This could be something as simple as an Excel spreadsheet or a system-generated report that shows the individuals and entities included in each client grouping, together with hours spent on them, total production or charges, write-ups and write-downs, and net revenue per client.

Prospects also may want to see a detail run of your book of business that shows, for the last year or current year to date, or both, all clients listed out individually, with hours, total charges, write-ups and write-downs, and net billings for each. Usually, you won't get to this level of disclosure unless someone's really serious about acquiring your practice. Just be sure you have a signed nondisclosure agreement before you release the information.

Continue Discussions Through to Closure

As you continue to share information with prospects, you'll be in a steady dialogue with them, answering questions and explaining what will be different from the last full year compared with the current year to date and the next fiscal year of the practice. For example, if in the last full year, your firm provided monthly write-up or bookkeeping services to a client group that had low realization due to problems with pricing or the client, you will want the prospects to know what you have done to resolve that. Similarly, if you took over the accounting for a new client last year and generated significant, unexpected fees from cleaning up messes left by his or her former accountants, you'll want the prospect to know that the fees for that client group most likely will be somewhat less this year than they were last year. Also, if a client group has left your firm or has been terminated, you will want to disclose that, as well, or better yet, just leave these clients off your reports in the first place.

At some point, prospects will start bowing out during any one of these phases as soon as they realize that they can't find a way for the deal to work or they have gathered all of the intelligence they want from this investigation. Unfortunately, some firms are vultures. They will look at your information; gather as much data as they can; and, when the sale of your practice is publicly announced, contact clients who you are trying to transition to the buying firm. It can easily be argued that this is not a violation of the nondisclosure agreement because, in many communities, firms already know your top clients (because they play golf with them, go to church with them, and so on). That is why you need to be ready and continue to work through this as if time is of the essence (mostly because it is—more on this in a minute).

On the other hand, rather than bow out, one or more of your prospects might make you a tentative offer. Obviously, unless they give you exactly what you are asking, you have just begun the negotiation process. Once again, keep every other prospect in the pipeline moving because the negotiation process can come to a screeching halt in an instant. For example, you might be offered a ridiculous amount with terrible payment terms because the prospect is a bottom-feeder (he or she is not looking for a fair deal but a one-sided deal that takes advantage of a desperate seller).

Besides pricing, the sale agreement typically includes other commitments between you and the buyer, such as you (the seller) agreeing to the following:

- Not compete with the buyer for a specific period of time
- Notify and sell your clients on the positive side of this transfer
- Personally meet with and introduce the buyer to your key clients
- Cooperate fully with respect to working papers, files, and so on

On the other side, the seller may ask the buyer to

- commit to meeting with key clients as soon as possible.
- get the transition process for all clients under way within a near-term specified time.
- work in good faith to build relationships in order to maximize the number of clients he or she keeps.
- notify the seller of any problems with clients so that the seller can step in and help salvage the relationship.
- pay you as agreed.

Also, you, as the seller, will want a provision in the agreement that the buyer agrees not to engage in any action or assist in any action against you with respect to services you provided your clients prior to the sale. Although it would be extremely rare, you just don't want the person buying your practice to instigate some sort of malpractice action against you.

We've attached a sample of a mutual confidentiality agreement one of our clients recently used to outline the terms of a sale as appendix B. As with all samples in this material, this is provided for your review to provide insight on the subject matter.

Keeping the Matter Confidential So That It Doesn't Get Out

It is imperative that your plan for a sale not be leaked to anyone during the planning and negotiations. This is especially true in smaller, closer-knit markets where everyone seems to know everyone and rumors fly faster than the wind. This means you need to take special care in placing and receiving calls, printing reports and summaries, saving electronic versions of that information, and delivering this documentation. You can never be too careful. We know of one firm that was entertaining merger negotiations that only the owner group knew about until one of them left a summary in the office copy machine, and a staff person found it the next morning. Needless to say, the possible merger was public knowledge throughout the firm in a matter of hours.

If your staff gets wind of the deal before its time has come, they will assume the worst, and you could find them heading off to work for your competitors or in some other line of business. So, what if they somehow find out before you expected to tell them? Get them into a quick staff meeting and briefly and succinctly tell them what's going on. Tell them why giving you a chance to work out the deal is a good thing for them. Tell them why it will be bad for everyone in the firm if news of the possible sale gets leaked to the clients and others before the deal is completed. Explain what your timeline is and that they will get a chance to meet and negotiate with the prospective buyer regarding their futures. Then, take the time to go through the office and meet with each person individually to re-recruit them

and calm any frayed nerves they may have developed. Reassure them that the prospect with whom you're working was selected by you because of what he or she could offer the people in your office and your clients.

Of course, this level of assurance also assumes that everyone you have is a player and a keeper. If you've put off dealing with a problem staff person that you don't think any other firm would want, you need to be very careful to not make any promises that would lead him or her to believe that he or she is in line for something that is not possible.

What about the clients and referral sources? Until you have a deal in the works, you don't want unmanaged communications going out into the marketplace. This results in twisted and inconsistent messages and, sometimes, just plain fabrications. Unorganized communications on your side (either from the buyer or seller) also will incite your competitors into action. Premature communications will significantly increase the likelihood of clients becoming nervous and making their own change to another firm before you have the opportunity to sell them on the alternative you have put together for them. Also, some clients, if they hear the word from some unofficial source, will take offense at the thought that after all of years of your working together, you didn't think enough of them to personally let them know you were going to make such a change. Keep it under wraps until you've got a signed agreement and a ready-to-launch communication plan, or you will be throwing money away (not the buyer's, just yours).

Announce the Change to Your Employees, Clients, and Referral Sources

To help make the transition from your firm to the new firm as seamless and successful as possible when it's time to go public with the news, you need to plan on spending a lot of time communicating with your people, your clients, and your referral sources about the change.

Employees

When the time is right, and assuming you haven't already had to perform damage control, you need to let your employees know the who, what, where, when, why, and how of the deal, focusing on what this change will mean to them. This is a serious change they will be facing, and they likely will be asking some form of the following questions of themselves; one another; and, hopefully, you. Here are just a couple examples of some questions and answers we have experienced:

Q: Why is this happening?

A: I've come to a point in my life where I want to retire and spend my time pursuing (fill in your list here). I wanted to find a way to provide you with a similar place to work, as well as a way to see that you could continue to serve the clients you have come to know over the years. I feel both you and our clients deserve this level of consideration.

Q: Is something wrong here or with us or me?

A: Absolutely nothing is wrong with any of us here [unless this is not true]. I just need to ride off into the sunset, and I wanted to find a way that will work for all of us.

- Q: What does it mean to me? Will I still have a job?
- A: I've talked with XYZ Company about all of you, and they're interested in talking with each of you [unless this is not true]. They want to line up some times to meet with you individually and get acquainted. As you know, nothing is guaranteed, but because you know the clients and they like working with you, XYZ Company is probably as interested in working something out with you as you are with them.
- Q: Even if I do get an offer from them, who are these guys, and how do I know I want to work for them?
- A: Part of my screening of potential candidates involved looking at how they run their business, how they're staffed, and so on, and I believe that any of you who cut a deal with them would be happy. However, during the interview, you need to be asking whatever questions you want answered because this is as much about whether you want to work for them as it is the other way around.
- Q: What will you expect from me as you're wrapping this up?
- A: I expect you to keep this quiet until I make the formal announcement to the clients and referral sources. They need to get one, consistent message about this, and I'd like to have all of you direct their questions, comments, and concerns to me. If someone probes you about what is going on, all you have to tell him or her is, "I appreciate your concern, and it's something that the owner is looking forward to talking about with you. I'll see that he calls you or drops by."
- I'd also like to ask you to keep an open mind and spend a little time with the people from XYZ Company if they express an interest in you. I think it will be a win-win for everyone involved.
- Q: What can I expect from you?
- A: I will be talking with each of you individually about your concerns and desires and will be available to provide you with whatever moral support I can. This isn't the end; it's the beginning of a new chapter in your career.
- Q: If we want to interview with some other firms, can we openly do so?
- A: Of course. I will provide a good reference for you, as well [unless this is not true]. However, because I will provide this reference anyway, I would appreciate it if you would wait until next week to hear what the management of XYZ Company might say before you look for, or certainly accept, any offers.
- Q: What about our pay? When is our last day?
- A: Everyone will remain at their current salary level through the takeover from the new firm. For those who decide to join XYZ Company, you will bridge from our payroll system to theirs without a gap. For those who decide to quit and join another firm, notice would be appreciated. Should anyone not want to work for XYZ Company or find another job by the time the transition begins, I will put together a severance package for you [if you know what that is, share it].

Other issues will likely surface, but the preceding questions and answers should give you an idea regarding a place to start. Remember, people don't necessarily resist change; they resist the ambiguity in their life that a change will cause. For some period of time, they'll be feeling as though they've lost control of their professional life, and they will be worried about what's just around the corner for them, especially if they've become really comfortable working in your firm. Your job is to eliminate the information vacuum as much as you can through constant discussion and feedback and by letting them know what you can, when you can. When an information vacuum exists, it usually sucks in enormous amounts of misinformation that will take a toll on your firm; your ultimate payoff from the sale; and all the people involved, including you.

Clients

It's really important to get your clients on the same page with you and the acquiring firm as soon as you can. If they stay with the buyer, your buyout will be larger; if they leave, they take their value with them. It's a simple matter of economics. Your clients need to know what you're doing, why you're doing it, and what you've done to take care of them under the change you are recommending. If you have a reasonably good relationship with them, most of them will appreciate the fact that you've taken the time to search through several firms to find the best fit for them. If some or all of your staff go to work for the buyer's firm, that will create a plus for you because the clients will have some familiar faces with which to work, however, you have to tell them about all of this.

Given that we're in a personal service business and we've developed some of these client relationships over decades, you can expect to experience a wide range of emotions when you begin to talk to your clients: everything from elation at the prospect of heading off in a different direction, to a sense of melancholy over the loss of the ongoing involvements you've had with them, to guilt for leaving them behind. While we're speaking of emotions, don't be surprised if some big, tough guys give you a hug and shed a tear or two as you visit with them. It can be a very humbling experience. Also, don't be surprised if some of them have other, unusual reactions. Occasionally, clients will actually react somewhat angrily to a change of this magnitude; they're ticked off that you're leaving them and that they are being inconvenienced to have to work with someone else. We have experienced clients' alluding that their CPA had an implied obligation to stay with them throughout their life. The stories go on and on, with everyone dealing with change differently.

Clearly, we think your client communications are critical, both on an emotional plane and an economic one. So, we recommend a couple of different passes at informing your clients about the pending transition. For key clients, we strongly recommend a personal call or visit to tell them the following:

- What you're doing.
- You searched far and wide to get a good fit in a successor firm for them.
- How the firm taking over the business is eminently qualified to do their work (you need to sell the buyer to them).
- Some of your staff, with whom they have relationships, will be transitioning to the new firm, as well.

- You will be available to help with the transition and questions.
- You really appreciate the opportunity to have worked with them throughout the years.
- It would be a personal favor to you if they would at least consider the firm you are recommending.

You then will probably want to follow up this visit with a letter letting them know to contact you if they run into any problems during the transition. The letter can restate what you covered in your conversation, and it can provide even more information to help them become more comfortable with the change.

You may want to take this same approach with those clients with whom you have had a long-term relationship, as well as low “B” level clients, even if they are small compared with the key clients. However, typically, time is of the essence here, so the seller will usually have his or her hands full just talking one-on-one with his or her key clients (“A” and high “B” level clients). This means that you need to incorporate a stopgap measure, at least until you can get to all of those you want to talk with personally. Communicate the preceding information via e-mail or letter, with a note that you look forward to talking with them soon. We’ve included a sample letter in appendix E, “Sample Letter Notifying Client of Change in Firms.”

The tone of the sample letter is one that shows concern for the client, as well as confidence in the new CPA firm. You really need to sell your clients on why they should give this new firm a try. It’s just as easy for them to interview someone else they know socially or who might have actually called on them in the past. Note that the letter does not refer to selling the practice or a sale. It does not say that you’ve already set them up with a new firm. You have to be very careful here. If you imply that you are telling them what they need to do or that you have sold them to someone, expect the backlash reaction of “Who do you think you are, ‘selling’ me to someone else?” Their reaction will likely be, “I’ll show you that you can’t ‘sell’ me!” So, the letter merely asks your clients for their permission to introduce them to the firm that you’re suggesting they utilize.

You also need to communicate with your “C” clients (those clients you don’t see much except at tax time with simple, straightforward returns). Obviously, it’s rare that you will have time to call them personally, so you should send a slightly modified version of the sample letter to those clients, such as the one we’ve included in appendix F, “Sample Letter Notifying Client of Change in Firms (Not Seeking Appointments or Meetings With a New CPA Firm).”

Also, you need to systematically get the clients to either approve the transferring of files to the new firm or to tell you where they want them sent if not to the new firm. We’ve included an actual example of how not to do this in appendix G, “How Not to Notify Clients.”

How about that last letter? We didn’t make it up; it was actually the first draft suggested by the owner of a firm that’s not a client of ours. Remember—we’re going to say it again—it’s a personal service business, and your retirement benefit is on the line. You need to do everything you reasonably can to assure that you don’t leave a lot of your money on the table.

As is the case with staff, you can't overcommunicate with your clients on this matter. If clients call and ask your people what's going on, the clients need a consistent message. Make sure you have a script made up for all your staff, from the receptionist to the manager, that basically says something to the effect of, "Yes, Joe's retiring. We appreciate your concern, and I know your issue is something that Joe is looking forward to talking about with you personally. I'll make sure he knows you called and that he gets back to you soon." Keep the messages consistent and coherent, and leave as little to chance as possible.

Be Available to Help With Transitioning the Practice

In order to help the new firm cement its relationship with your clients, you'll need to plan on spending quite a bit of time at the front end of the changeover. As we've outlined in the preceding sections of this chapter, you'll need to be sending letters and e-mails and calling clients to announce the deal and setting up meetings between your clients and the new CPA firm's representatives. However, it doesn't stop there. You'll also be providing a "brain dump" to the new firm to let them know as much as possible about the key clients and their likes, dislikes, eccentricities, and foibles. The following is a client communication action plan template for your use in planning your practice transition:

- Draft letters to clients in advance of closing for mail-merge preparation and processing of letters.
- Upon closing the deal, send out letters, e-mail and call key clients, and distribute script to staff and discuss it with them.
- Follow up initial communications with calls to key clients to set up appointments to meet with new firm owner or employee.
- Review key clients with the new CPA firm owner.
- Meet with key clients and the new CPA firm owner.
- Be available to talk with the new CPA firm about clients' files and activities, as required, for a seamless handoff.
- Be available for clients to call you with complaints about the new firm.
- Make yourself unavailable for answering clients' tax and accounting questions; refer them to the new firm. With every technical question you answer, you are undermining the work everyone has done thus far trying to make the transition work. Be strong and be quiet.

We've already covered the nature of initial communications and announcements listed under the first two bullets, so we'll move right into the third action step.

Follow Up Initial Communications With Calls to Key Clients to Set Up Appointments

You need to contact key clients as soon as possible to set up meetings with them to introduce the new firm owners. Take swift action to help allay any fears and minimize their anxiety over the change you've just announced. Try to get them set up during the first couple weeks after the announcement so the new firm can begin their efforts to integrate them into the practice. Recognize that these phone calls may run a little longer than you might expect,

due to the clients wanting to ask you about your decision, the new firm, your people, and other matters of interest. Always remember it's a relationship business. Don't cut calls short when clients need to talk with you about this because it's incredibly important to them.

Review Key Clients With the New CPA Firm Owner

Although you've already discussed key clients with the new firm owner as you negotiated your deal, you'll probably need to spend some time with him or her again once he or she has the files in front of him or her. This will allow you to more fully explain the clients' situations, nature of their business and other activities, likes and dislikes as they relate to accounting services, and eccentricities that the new firm owner should know. This review is preferably done before both firms go into the initial client get-acquainted meetings. We've found that it doesn't hurt to reiterate some of the key facts on the way to an individual meeting, even if the new firm representative has just scanned the file and you've covered this before in a previous meeting. Your clients will make up their minds about whether to give this firm a chance within the first 10 minutes, so you want your initial minutes of contact to be as orchestrated as possible.

Meet With Key Clients and the New CPA Firm Owner

Once you've scheduled the meetings, now it's time to perform. This is your opportunity to

- introduce the new firm.
- sell the new firm and why you've arranged for them to be available to your client.
- let the new firm owner talk to the client, answering client questions and assuring the client that he or she wants the client's business.
- let the client know you'll be providing transitional assistance to the new firm to minimize the client's disruption from this change.
- let the client know that, although it's unlikely based on your prequalification of the new firm, if the client has any complaints about the new firm, he or she should let you know and you'll see that they are addressed.
- express your gratitude again for the long-term relationship your client has had with you.

You need to take advantage of this time together with the client and the new CPA firm owner to really sell the client on the new firm. The client is not required to use any firm in particular. He or she can go anywhere he or she wishes for his or her accounting and tax needs. Your discussion with the client during this meeting needs to help him or her see that, although he or she can go elsewhere, this new firm is an excellent choice and at least worth taking for a test drive. You'll probably kick off the meeting with introductions and selling the new firm and then shut up. The more you talk, the less time you give the client and new owner to establish a relationship. It doesn't matter that you would handle something they are discussing differently or that you would have explained a topic more clearly because you are bowing out. Don't use this meeting to convince the client that he or she needs you. Let the new firm answer questions, build rapport, and assure your client that the new firm really wants their business.

You may be asking yourself, “What’s involved in ‘selling’ the new firm?” What we’re referring to here is a restatement of the material you covered in your first letter, explaining and expanding on the process you’ve gone through to find these people and why you selected them to be available to help your clients handle their business and personal needs. Your client needs to know that the new firm is special to match the fact that the client is special.

How long should these meetings take? It depends. They typically run from approximately 30 minutes to 1 hour. Leave yourself time to conduct meetings of up to 1 hour in duration so you don’t get jammed up and behind schedule. Some clients will want to spend more time talking with you, and especially the new CPA, than others. You know what we’re going to tell you again—it’s a relationship business. Honor that and make sure you do all you can to help get your buyer’s relationship with your clients off to a good start.

Be Available to Talk With the New CPA Firm About Clients’ Files and Activities

After the new firm takes over, from time to time, there will be some need for your assistance. This might involve the new firm’s getting your input on something that a client has asked them. For example, the new CPA may call you and tell you about a conversation that he or she had with a client in which the CPA felt that the client was off base, and the CPA may just want to verify with you how you and the client had been handling that type of issue in the past. In other cases, you might need to help the new CPA firm understand methodology, calculations, or locations of information that the new firm must use to help the client. Yes, we know that you keep impeccable records and that your files are organized, indexed, and complete. However, matters of interpretation will arise, and you can make the transition much more painless for the clients, thereby assuring your buyout value, if you spend a little time helping the new CPA firm understand how you have handled transactions and issues in the past.

Most acquiring CPA firms don’t really want you to hang around for very long after the sale, if at all. If you were to continue working in the practice after the sale and expected some remuneration for your time there, it could quickly ruin the economics for the buying firm, unless it had no one else available to perform the activities you’d be doing. Consider also that your presence after the sale may not be helpful in getting the clients to develop relationships with the new owner. Also, put yourself in the place of the buyer. Would you want a selling CPA hanging around in the middle of your operations after you bought his or her practice? What kind of havoc could that wreak? For all of these reasons and plenty more, buyers will want the seller to be available for 3–6 months by phone or to occasionally come in for a meeting but certainly not to be hanging around the office during that time.

Be Available for Clients to Call You With Complaints About the New Firm

You will probably recall that we previously suggested you tell your clients that you’d be available to them if their needs weren’t being properly met: they could call you if the new firm dropped the ball. This availability on your part should help create enough comfort for

most of them to give the new firm a try because they will know they can still talk to you about problems they might encounter with service, and you will see that the new CPA firm owners hear about them.

Having said that, we believe that this role is best handled in a passive manner. Be there when they call, ask them how things are going when you see them at a social event, but don't insert yourself into their relationships with the firm. Let them work out their own issues. Your old clients will call you if they reach an impasse. Every time you stick your head into their situation, you have a chance of unraveling the situation. You've told all of your clients prior to the transition that you'd be available if they had any problems and that's usually enough. Don't cause problems when there are none.

Make Yourself Unavailable for Answering Clients' Tax and Accounting Questions

This last imperative is a tough one for some of us. Our clients are friends we've known for many years. We truly care about them and have a pattern of behavior of responding to them when they have needs or questions. Old habits are hard to break, but you need to quickly break this one. Some of your clients will be inclined in the short run to track you down and ask you to be a sounding board for them. You probably should listen briefly to the issue and let them know that, yes, it's an interesting question; you can appreciate their need for some guidance and direction; and that the new CPA will be able to help them with that. If that doesn't seem like the right approach, you can suggest that you would like to think about their issue and that you and the new firm will call them back tomorrow. When you call back, shut up and let the new firm representative build credibility by explaining the answer, even if you are the one who came up with it. The bottom line is that for successful transitioning to occur, you (the seller) need to become selectively incompetent. This is a very difficult thing for a skilled professional to do, but by becoming dumber and dumber, you put the replacement people in the position of looking smarter and smarter. Although you want the client to like you, respect you, and maintain a personal friendship with you, you also want that client to feel like your retirement has let them trade up, so to speak, regarding the advice they are now receiving. If your ego can't handle this, no problem; however, rest assured that although your ego will be satisfied, your pocketbook will take a beating.

As tough as it is, you need to step away from client contact. If you don't, you will impede the building of the bonds and the client relationship between the acquirer and your clients. This can only hurt you in the long run. If you've done a good job finding the right buyer, you need to let the new firm handle these issues, knowing full well that your clients will be better off because of it.

A Final Note on Selling Your Practice

Any major change in life generates a combination of emotions, from shock to anger, grief, happiness, and everything in between. Selling your practice will bring out some of these feelings. In the final analysis, if you've done your homework and followed a sound plan for the sale and transition, you should recognize reasonable success and monetary reward for your effort.

In order to assist you in putting together your plan, we have organized some of the concepts we covered in this material into a sale checklist (see appendix H, “Steps to Consider in Selling Your Practice”). This document is a good place to start, but you need to customize it by adding, deleting, and modifying the steps so that it will work for you and your situation.

Businesses are bought and sold every day. What makes the sale of a professional practice different is the intensity of the relationships normally built up between the owner and the clients. This intensity can make it more difficult to effect a smooth transition. Clients often tell the former CPA, “Yes, we’re doing fine with the new firm. They’re doing a good job for us, but it’s not quite the way you used to do it.”

Take all of this in stride. Some of it is said out of respect to you. Some of it is real, and they wish you were back serving them. However, your role any time you hear comments like this is to ask, “Is there something you want me to say to the new firm?” You also can simply say, “Thank you for your kind words.” Staying involved will undermine the relationship. You want your old clients to know you are there for them if problems occur, but you also want to constantly remind them of the quality reputation and work that the new firm is known to produce. This approach cements your role as someone they can still come to, but it also reminds them that their current CPA firm is worth getting to know better.

It’s a relationship business, and you built some of those relationships over many years. Give the new firm at least a couple years to allow their roots to take hold. By taking this approach, you will be doing your part to transfer the relationships to the acquiring firm, and your reward should be to sit back, collect your checks from the sale, and enjoy life.

Appendix A

Using the Transfer of an Accounting Practice Checklist

We've created the following checklist to provide you with a tool to help you sort through options you have and firms that may be likely candidates to buy or merge in your practice. The checklist is designed around 10 key areas that we've found can make the difference between successful transfers and dismal failures. These areas are as follows:

- Cultural compatibility in general
- Compatibility of owners
- Strategic perspective
- Compatibility of client base and service offerings
- Compatibility of performance management and pay systems
- Compatibility of firm ownership and governance models
- Compatibility of businesses processes and practices
- Compatibility of succession management processes
- Overall stability of the acquiring firm
- Other factors

The checklist is organized with the following columns for exit planning strategy: sale, merge upstream, buy or merge in, transfer within seamlessly, and turn out the lights. If you see a highlight in a box opposite a description under the type of transaction you're considering, you probably will want to consider that factor in assessing the fit of your practice with that of the firm you're considering selling to or merging with. The chapters dealing with these transactions refer to these factors, so you can read the related sections in those chapters to gain more background on any particular factor covered in the checklist.

Keep in mind that, for the most part, these are qualitative factors that you must consider and think through. There's no, one "right" answer here and no multiple choices. The idea is for you to use this as a mental model to help you decide which path to pursue. Then, if you decide to transfer the practice to another firm, it will assist you in finding a compatible practice on your way out, thereby putting a little more security in the mix for your ultimate buyout. This checklist doesn't take the place of traditional, quantitative due diligence procedures. It should probably be completed first, before you waste time going through minutiae for deals that don't make sense for you.

You can print off a copy of the checklist and use it to help score (relatively speaking) the desirability of candidates who might be buying you out or merging you in or whom you might be merging in or buying out, as well.

Securing the Future: Taking Succession to the Next Level

Factors	Sale	Merge Upstream	Buy or Merge In	Transfer Within Seamlessly	Turn Out the Lights
Cultural Compatibility in General					
• “How we do things around here”					
• Core values in action					
Compatibility of Owners					
• General styles and style differences between and among owners					
• Collegiality among owner group—how they talk to, with and about one another					
• Nature, level and types of conflicts within owner group, if known					
• Ages of owners and how well spread over next two decades					
• Gap in book size between owners, differences in leverage, general approach to business and life					
Strategic Perspective					
• Existence of firm long-term direction, strategy, or vision shared by all owners					
• Use of strategy to drive budgeting, operations and behaviors of owners					
• Compatibility of owners’ strategies					
Compatibility of Client Base and Service Offering					
• Industries served					
• Nature of clients served					
• Service offerings provided to clients					
• Service policies and practices					
• Charge rates, fee structure					
• Geographic locations and differences among locations					
Compatibility of Performance Management and Pay Systems					
• Performance metrics in use by owners					
• Articulated compensation system used by owners					
• Owner fringe and benefit policies—insurance, cars, clubs, dues, CPE, vacation, etc.					
• Leadership development practices for junior partners and managers					
• Staff performance metrics used					
• Staff ages, backgrounds, pay and benefits					

Factors	Sale	Merge Upstream	Buy or Merge In	Transfer Within Seamlessly	Turn Out the Lights
Compatibility of Performance Management and Pay Systems (continued)					
• Staff policies for other than pay and benefits, CPE, CPA exam, flex-time, child care, civic involvement, etc.					
• Staff evaluations—nature and frequency, including career-pathing					
Compatibility of Firm Ownership and Governance Models					
• Formal or Informal requirements for admission as a partner					
• Spread of current equity ownership among partners					
• Governance model used—committee, managing partner with committee, managing partner, unclear					
• Decision-making processes—consensus, majority vote, managing partner, etc.					
• Standard operating procedures in place for decision-making, conflict resolution, voting, partners' duties					
• Roles and responsibilities defined for partners and staff					
• Existence of one signed owners' agreement					
Compatibility of Business Processes and Practices					
• Types and quality of communication within the firm—formal and informal					
• Formal or Informal business development processes in place					
• Billing and collection practices					
• Standardized administrative processes in place—internal accounting & timekeeping, workpaper preparation, review, filing, paperless or other, etc.					
• Amount of leverage—partner to staff time					
• Firm staffing structure—pyramid, inverted pyramid or other					
• Extent of functional specialization and niches					
Compatibility of Succession Management Processes					
• Formal or Informal succession management plan, and implementation being done to achieve it					
• Expected retirements within next five years—who, how much equity and cost to firm, as well as amount funded, if any					

(continued)

Securing the Future: Taking Succession to the Next Level

Factors	Sale	Merge Upstream	Buy or Merge In	Transfer Within Seamlessly	Turn Out the Lights
Compatibility of Succession Management Processes <i>(continued)</i>					
• Written documentation nailing down exactly when senior partners will be retiring and their expected payout under current policies					
• Likelihood acquirer will itself be merged upstream or sold					
Overall Stability of the Acquiring Firm					
• Investment in people					
• Investment in technology					
• Appropriate leadership in place					
• Absence of critical, unresolved issues among owners					
Other Factors					
• How will or can we undo this if it is not working?					

Appendix B

Sample Mutual Confidentiality Agreement

THE AGREEMENT made as of the _____ day of _____, 20XX, by and between ABC, a [professional service corporation, a partnership, or sole proprietor], of [city and state] (hereinafter referred to as ABC), and XYZ, a [professional service corporation, partnership, or sole proprietor], of [city and state] (hereinafter referred to as XYZ).

WHEREAS, ABC is presently operating an accounting practice being served from an office in [city and state]; and

WHEREAS, XYZ is presently operating an accounting practice being served from an office in [city and state]; and

WHEREAS, ABC desires to explore the transfer to XYZ the right to service the clients served by ABC from its [city and state] office; and

WHEREAS, in the course of exploring such an agreement ABC and XYZ may need to provide access to, non-public, proprietary information and materials concerning the operations of each other including but not limited to information about its business practices, management, partnership agreements, finances, marketing or strategic plans, contractual arrangements; staff compensation and billing rates, client fees and profitability; and

WHEREAS, both parties regard it essential to their business purposes to guard against the use of this information by the other party in the course of any future contact with the staff or clients of the other;

NOW, THEREFORE, in consideration of the mutual promises herein made and the considerations herein expressed, the parties hereto mutually covenant and agree as follows:

1. *Treatment of Confidential Information.* Neither party shall use the confidential information of the other party nor circulate it within its own firm except for the extent necessary for analysis of the feasibility of the potential acquisition of ABC.
2. *Return of Confidential Information.* Should the acquisition of ABC by XYZ not occur, both parties agree to return all confidential information to the other party without retaining any of the information in any form.
3. *Survival of Agreement.* This agreement shall survive the termination of discussions between the parties.
4. *Amendments.* This agreement may not be amended except in a writing duly executed by both parties.
5. *Governing law.* This agreement shall be governed by and construed in accordance with the laws of [state] and with applicable federal laws and regulations.
6. *Severability.* In the event that any portion of this agreement is found to be void, illegal or unenforceable, the validity or enforceability of any other portion shall not be affected.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement the day and year first above written.

(From the AICPA *Management of an Accounting Practice Handbook*)

Appendix C

Sample Staff Listing

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Name & Position	Charge/Pay	Tenure with Seller PC	Prior years of experience	Educational background	Other information
Lucy Diamond Receptionist/administrative assistant	\$60 \$16/hr + OT	5 years	~ 20+		Assembles, prints paper/e-returns, financials, billings, etc.
Rachel Rabbit Accounting intern	\$40 \$12	~ 1 year	N/A	Due to graduate December 200X from ABC University	Learning the ropes; understands our systems Works on the some write-up accounts Has worked on reviews and does some tax prep
Jackson Mars Associate (staff accountant)	\$70 \$37K/yr, incl 150 hrs OT	~ 8 months	N/A	Graduated from ABC University May 200X-1.	Also understands our systems Has experience working as a staff accountant on audits and reviews and doing tax prep Good questions & thinking ability
Mitzi Gaynor Associate	\$85 \$39K/yr, incl 150 hrs OT	1 year as full-time accountant, plus one busy season as an intern	Previously worked in an HR job through college at a large company	Graduated from ABC University May 200X-2.	Also understands our systems Has experience working as a staff accountant on audits and reviews and doing tax prep
Alice Toaklund, CPA Experienced Tax Senior	\$115/hour \$32.50/hr	Has worked with me for ~ 20 years	Previously worked at State Health Dept as dietician	Graduated about 1990 from XYZ University Passed exam shortly after	Has some client contact; oversees write-up jobs; does complex returns; FT during tax season, PT rest of year
Leonard Tolstoy, CPA Technical Tax Manager	\$140/hr \$75K/yr	~ 10 years	~ 20 years, starting w/ Cheatum & Chiselem in Pocatello	Graduated ~ 1980 from MNO College	Works three days in office; 2 days from home Good technical and research skills
Bobby McGee Intern applicant	Would be at same rate as Rachel Rabbit	None yet	See resume, attached	See resume, attached	Bright, mature young person w/family; motivated to succeed Was interested in internship, but was not hired due to timing of practice sale

Appendix D

Sample Practice Summary for a Firm That is Being Sold

Audit and review includes amounts for (mostly) contractor book of business:			
	Annual Estimate		
Heavy underground contractor audit & taxes	40	(incl 401(k) audit)	
Specialty subcontractor review & taxes	15		
Specialty subcontractor review & taxes	15		
Specialty subcontractor comp & taxes	30		
Homebuilder taxes	5		
Heavy underground contractor audit & taxes	50		
Specialty subcontractor review & taxes	15		
Homebuilder/comm contractor review/taxes	15		
Paving contractor review & taxes	15		
	200		
Miscellaneous, reviews	50		
Medical group review and taxes	20		
	270		
Tax and comp includes various other businesses, e.g., MD's			
	Annual Estimate		
Industrial/auto parts-wholesale/retail corp	15		
Surgeon corp and 1040 + P/sharing acctg	15		
Surgeon corp and 1040 + real estate + farm	15		
Surgeon + farm	15		
Surgeon + related real estate & other entities	25		
Private placement R&D LLC tax + audit prep	25		
MD 1040's	10		
Med practice LLC + 1040	10		
Chiropractor	5		
	135		

This summary shows total fees from some major client groups. These totals include taxes and assurance services, so they don't total to categories shown above.

Appendix E

Sample Letter Notifying Client of Change in Firms

Dear Client:

I've decided to retire from the practice of accounting and spend more time with my spouse, doing some of the things we've dreamed about for years—traveling, spending more time on the trout stream, and spending a lot more time with our grandchildren.

Once I decided to retire, my attention immediately shifted to you! You are important to me, both as a friend and a client. Therefore, I wanted to find and recommend a new accountant who (1) I respect, (2) will take great care of you, and (3) has a similar service philosophy. After interviewing firms for the past couple months, I am pleased to recommend XYZ Company as a firm ready and anxious to work with you.

The managing partner of XYZ Company, Jane Doe, and I started out together in the profession of public accounting more than 30 years ago. She has been running her own firm since 1989. She and her young, energetic partners and 15 staff are an impressive group. They are known for their expertise in the _____ industry and serve clients in that industry throughout the state of _____.

My staff accountants, Jackson, Mitzi, Alice, and Leonard, have accepted full-time positions with XYZ Company, and they look forward to continuing to serve you through the new firm. As you may know, they did quite a bit of the work on your account and are familiar with your situation.

I would consider it a personal favor to me if you would allow me the opportunity to arrange a time to introduce you to a partner from XYZ Company within the next couple weeks. I will be calling you soon to discuss this change and answer any questions you might have.

[Name], I really appreciate the opportunity to have worked with you all these years, and I will definitely miss that as we go forward. Thanks for everything!

Sincerely yours,

Selling CPA

Appendix F

Sample Letter Notifying Client of Change in Firms (Not Seeking Appointments or Meetings With a New CPA Firm)

Dear Client:

I've decided to retire from the practice of accounting and spend more time with my spouse, doing some of the things we've dreamed about for years—traveling, spending more time on the trout stream, and spending a lot more time with our grandchildren.

Once I decided to retire, my attention immediately shifted to you! You are important to me, both as a friend and a client. Therefore, I wanted to find and recommend a new accountant who (1) I respect, (2) will take great care of you, and (3) has a similar service philosophy. After interviewing firms for the past couple months, I am pleased to recommend XYZ Company as a firm ready and anxious to work with you.

The managing partner of XYZ Company, Jane Doe, and I started out together in the profession of public accounting more than 30 years ago. She has been running her own firm since 1989. She and her young, energetic partners and 15 staff are an impressive group. They are known for their expertise in the _____ industry and serve clients in that industry throughout the state of _____.

My staff accountants, Jackson, Mitzi, Alice, and Leonard, have accepted full-time positions with XYZ Company, and they look forward to continuing to serve you through the new firm. As you may know, they did quite a bit of the work on your account and are familiar with your situation.

Jane's office will be in touch with you shortly. I would consider it a personal favor to me if you would at least give them a chance to sell you about why they are the right firm to take care of you. Please call me with any questions or if you are uncomfortable in any way with Jane Doe's people after you talk to them.

[Name], I really appreciate the opportunity to have worked with you all these years, and I will definitely miss that as we go forward. Thanks for everything!

Sincerely yours,

Selling CPA

Appendix G

How Not to Notify Clients

Dear client:

I regret to inform you that I am leaving the firm to pursue a full-time avocation of fishing and hunting, and traveling with my wife. As a result of my departure, my ABC Firm will no longer provide tax and accounting services to you from this date forward. I have arranged with XYZ Company to provide these services to you.

If you should wish to be served by XYZ Company, we will release information pertaining to your account, upon receipt of your authorization to do so. If you wish someone other than XYZ Company to receive your records please indicate that on the enclosed authorization form.

To affect the release of information pertaining to your account, you need to sign the transfer request enclosed and return it to me in the envelope provided. The transfer request should be sent to me at [address].

I would like to assist you in an orderly transition, and I look forward to receiving your authorization.

Sincerely,

Selling CPA

Appendix H

Steps to Consider in Selling Your Practice

Suggested Activities for Retiring CPA	Comments	Target Date	Completion Date
<ul style="list-style-type: none"> Identify likely candidates to buy your practice, based on factors identified in the Transfer of an Accounting Practice checklist. 			
<ul style="list-style-type: none"> Contact potential buyers and discuss the potential sale of your firm briefly and conceptually with them in the following manner: <ul style="list-style-type: none"> Initial contact—Call managing partner or CEO of likely prospects. Conduct subsequent discussion if interest exists after initial contact. 			
<ul style="list-style-type: none"> For prospective buyers interested in pursuing discussions <ul style="list-style-type: none"> prepare a nondisclosure agreement for prospective buyers to sign. obtain a signed nondisclosure agreement from prospective buyers. provide prospective buyers with a high level summary of practice statistics, such as the performance metrics we covered in the previous chapter. 			
<ul style="list-style-type: none"> If further discussions are warranted at this point, provide the potential buyer with more detailed information on client groupings and your personnel. 			
<ul style="list-style-type: none"> Continue discussions through to closure in the following manner: <ul style="list-style-type: none"> If discussions lead to no deal, consider adding another prospect to your list. If discussions lead to signs of a deal, prepare a preliminary draft of the business terms (letter agreement) and provide it to the prospect. Discuss and negotiate letter agreement with the prospect. Send draft letter agreement to legal counsel to convert into a contract for sale. 			
<ul style="list-style-type: none"> Stay focused on keeping this matter confidential so that it doesn't get out to your staff or into the community until you're ready to announce a deal. 			

(continued)

Securing the Future: Taking Succession to the Next Level

Suggested Activities for Retiring CPA	Comments	Target Date	Completion Date
<ul style="list-style-type: none"> • Announce the deal to your employees, clients, and referral sources in the following manner: <ul style="list-style-type: none"> – Discuss the deal with employees as a group. – Follow up group discussion with individual discussions with each employee to re-recruit them. – Let buyer know when you've completed the preceding steps. – Call key clients to let them know what's happening. – Follow up with letters and e-mails to key clients. • Send letters and e-mails to the rest of your clients. 			
<ul style="list-style-type: none"> • Be available to help with transitioning the practice and the clients to the new firm in the following manner: <ul style="list-style-type: none"> – Contact key clients to set up meetings with them, the new CPA firm representative, and you. – Meet with key clients and the new CPA firm representative. – Go over specific likes, dislikes, and nuances of each key client with the new CPA firm owner. – Be available to talk with the new CPA firm about clients' files and activities. – Be available to clients for their calls with complaints, but stay out of the new firm's relationship with them unless the clients contact you. – Make yourself unavailable and selectively incompetent when clients try to engage you in providing technical advice. Either refer them back to the new firm or set up a call between you, the client, and the new firm representative, and set the new firm representative up to shine when discussing the client situation. 			

Chapter 5



Merging Your CPA Practice Either Upstream or Downstream

Introduction

In this chapter we discuss what you should consider if you are planning to merge your practice into another CPA firm (upstream) or merge practices into yours (downstream), rather than transitioning it internally or selling it to outsiders. As you may know, some of the steps and many of the tips and considerations covered in the early section of chapter 4 called “Steps in Selling or Merging a Practice” apply to both sales and merger, so if you haven’t looked at that material, we encourage you to go back now and review it before moving on. In this chapter, we will be covering yet more material on the steps you might take in arranging for a merger of your practice. While some of the steps and recommendations in this chapter are similar to those listed for the sale of a practice in chapter 4, the differences and nuances warrant a careful review of this material. If you’ve read through the material on the sale of your firm, you might be inclined to skim through some of the following sections because the information seems so familiar. However, we have added, changed, or deleted sections to make the material relevant to the merger topic. So, for the sake of getting the most out of this that you can, hang in there and give this a thorough read.

Steps in Merging a Practice

We introduced the following steps in Chapter 4 and covered the first step, “Identify likely candidates with whom to merge” in detail there. In this chapter, we will cover the rest of the steps as they apply to mergers:

- Identify likely candidates with whom to merge.
- Contact potential candidates and discuss the potential merger of your firms briefly and conceptually with them.
- For prospects interested in pursuing discussions
 - prepare a nondisclosure agreement for prospective merger candidates to sign.
 - provide prospective merger candidates with a high level summary of practice statistics, such as the performance metrics we covered in the last chapter, and obtain similar information from them.
- If further discussions are warranted, provide the potential merger candidate with more detailed information on client groupings and your personnel, and obtain similar information from them.
- Continue discussions through to closure.
- Stay focused on keeping the matter confidential so that it doesn’t get out to your staff or into the community until you’re ready to announce a deal.
- Announce the deal to your employees, clients, and referral sources. This is an especially important step requiring careful consideration if your firm is merging into another firm (upstream).
- Actively participate in merger integration between the two practices.

However, before we go into the steps you will likely pursue in merging a practice, it would be good to understand why or why not you and/or your partners might want to merge with someone in the first place, either as an acquiring firm in a downstream merger, or as a merged-in firm in an upstream merger.

What Do the Partners Say They Are Looking for From the Merger?

To us, this is an important starting point. In order to try to minimize confusion as we talk through this, we would like to introduce a couple terms we’ve coined to add clarity:

- A *mergee* is the firm that is merging into the controlling firm. In other words, the mergee will be required to be integrated into the other firm’s practice. We also refer to this as an *upstream merger*.
- The *mergor* is the firm that will be the controlling firm after the two firms come together. It will be the mergor’s rules, processes, and policies that will be followed after the merger is complete. Typically, the mergor is the larger firm of the two. We often refer to this as a *downstream merger*.

So, back to the question at hand: what's the pitch? The problem with this topic is that, in reality, it is filled with hype. It is hard to determine the real reasons for merger because they are shrouded in platitudes and self-aggrandizing statements. In other words, either or both the mergee and mergor convey attitudes, skills, abilities, teamwork, synergies, cooperation, operating processes, governance, business development, training, culture, and so on that really don't exist. It is an interesting dance to watch because both parties position themselves as needing nothing but are willing to make significant compromises to complete the merger transaction. The bad news is that the parties to the merger will never follow up on many of the compromises committed to during this dance or certainly won't enforce them.

Logically, the larger the firm, the more that it is governed to implement accountability almost everywhere but at the top. This is the rub with professional service firms—rarely do you find accountability and required compliance at the very top. Regardless of size, that top layer of 1–10 partners (sole proprietors are included in this) who oversee operations are the people holding powerful positions within the firm, are the larger stockholders (or control the largest books of business), and usually do what they want. If you have a firm with 50 partners, this issue isn't so critical because 40–45 of the partners are held to expected roles and standards. However, when you are a firm of 1, 3, 5, or 8 partners, having this group do whatever they want can be a very dangerous operation style for the firm.

Where is this leading us? Generally speaking, sole proprietors, firms with fewer than 10 partners, and the top 10 partners in a very large firm all have one thing in common—they do as they please. This group is very good at setting standards for others to operate within and comply with but very bad at holding themselves accountable to the same standards. So, any time you are talking with members of this elite group, be aware that you will have difficulty distinguishing between the realities of what they are willing to require others to do versus what they are personally willing to be held accountable for. For these people, rules are okay—for everyone else.

Why is this so important? Because if a four partner firm (with all owners having approximately equal ownership) is looking to merge with a one owner firm, the odds are that no one at that table has ever actually submitted to one of the other partners' authority to be held accountable to them. So, these groups spend a lot of time dancing around the strengths and weaknesses of the merger and the synergies and leverageable areas between the practices. In the end, you might find it difficult for any of those outcomes to materialize.

To further illustrate this and make this less personal, we will share the following situations that were highlighted in our work with firms that joined consolidators years ago. The goal of the consolidators was easy to understand, it was a valid concept, and it had plenty of potential. If a consolidator could take a bunch of small firms with talented people and join them together, everyone could immediately pick up economies of scale and sophistication in the firm's infrastructure. These economies could basically make up the profit contribution required by the consolidator, even if revenues stayed about the same. Additional growth opportunity existed to actually increase the profit pot for everyone by getting these talented sole practitioners to continue taking care of their clients as they had been while

bringing in members from other merged firms to assist in specialty areas when unique skills were needed. This network and support structure, in turn, would allow all the sole proprietors to specialize a little more than they could on their own. By specializing a little more and utilizing the new network, the current service risk experienced by most sole proprietors due to conducting the many one-off engagements they typically handle while trying to be all things to their clients would be minimized. (Theoretically, the work also would be more profitable because of the talent pool available to assist with it). On paper, all of this was a creative and exciting strategy.

The problem came when the consolidators tried to get these partners (the top 1–10 partners in the firm) to do any of the things they committed to do when agreeing to merge. First, these partners didn't want to bring in other CPAs to work on their client base. This occurred because of a couple standard reasons. The predominant reason was that they didn't want some outsider providing a marginal (or superior) service creating client dissatisfaction (the superior service might prod the client into realizing he or she had been using the wrong CPA). It is the same client hoarding phenomenon that we see in most firms that still operate the firm around the book of business model. You might ask, "If this firm merged into the consolidated firm, why would it protect its client base when it was paid to merge?" Because it was always positioning itself so it could take its clients and leave as soon as it couldn't stomach what the folks at corporate headquarters wanted it to do.

To many CPA partners, merging their firm is win-win. If the larger firm is easy to work with, pays them a lot, and is not too demanding then they have made a good choice. However, if it doesn't work out, as long as they maintain strong client relationships, they can always walk away and take everything with them. In other words, the commitment to the merged firm was never really there, and this whole combination was about (1) providing the sole proprietor with more resources so he or she could make more money without having to make the required investments and (2) having access to other people for management of the administrative functions.

In our experience, another common barrier to success in trying to bring in talent from the consolidator's network was that many, if not most, of the sole practitioners had billing rate structures that supported their required quality of life rather than market values. Therefore, clients might not be as inclined to want to hire these outside specialists due to sticker shock. Because the sole proprietors made as much money as they felt they needed, they never saw the real value in rocking the boat with their clients to shift their fee structure to fall in line with other competitive firms.

The second reason consolidators couldn't get these partners to create the bigger value they saw through merger was that, although the consolidators could get the smaller firms to go along with their firm administrative rules and requirements, when it came to creating standards and operating processes for servicing clients, client acceptance, pricing, and so on, they often failed miserably. Owners who have had the freedom to do the work their own way find it difficult to be held to someone else's standards (unless those standards are consistent with what they personally believe).

So, after learning from these experiences, consolidators started merging in larger firms. The advantage is that larger organizations usually are driven by more processes, operating procedures, budgets, goals, performance management, and so on. Given the difficulty of managing smaller firms, larger firms seemed like a much better way to go, and for some, it was. However, the consolidators found out that this was no panacea, either. They found that, depending on the performance standards set by the consolidator, as well as the merger terms for each firm, the larger firms wouldn't share staff or capability with other firms, either. Most commonly, this was because the senior partners in the office who provided the assistance would receive less personal income if they shared their resources with others than if they hoarded their capabilities and waited for an opportunity to serve their own clients.

In other words, the top echelon of management, regardless of firm size, is still deciding what to support or ignore based on what is best for them. Partner compensation planning is so important because people have the greatest chance of supporting the firm's initiatives when those initiatives are lined up with their personal goals.

The bottom line is that when you deal with the top echelon of partners in almost every CPA firm, regardless of size, be wary of what they commit to doing in order to make a merger work. The mergor firm partners are not the issue here because the mergor senior partners will continue to do exactly what they are doing now. It is the commitment and willingness to be held accountable by the mergee partners that you have to spend more time understanding. You can use this rule of thumb: add the words "as long as I decide that this request is in my best interest" to the end of any commitment made, especially early on in the merger discussions.

Now that everyone realizes the importance of understanding partner commitments and the difficulty of compliance, it starts to become clear that the mergor firm needs to be very clear regarding the expectations of the mergee partners and then tie those expectations and accountabilities to a compensation plan right at the outset of the deal.

Why Mergee Firms Might Be Looking for an Upstream Merger

Regardless of the marketing spin talented CPAs use to cover up their weaknesses and display their strengths, typically, mergees are looking for a way out of the management nightmare they have created. That nightmare could be any number of hundreds of issues but, as an example, might look like one of the following:

- We can get more for our retirement benefit from a merger than from selling our interests within the existing firm.
- We don't believe that the remaining partners have the leadership ability for the firm to continue over the long run and pay us off.
- We don't believe that the firm will stay together after we leave because the rest of the partners can't get along or develop a common focus and strategy for the future of the practice.

- We have some partners who refuse to be held accountable and function as a partner by doing what's necessary for the good of the firm, and we can let the new company deal with them.
- We are short on talent, either at the junior partner level or the next tier down in the hierarchy of the firm, so we need to join in with someone else.
- Our financial results are not particularly shiny, and we want to join a firm that has good financial bottom lines for partners to help us with ours.
- We have a specialty niche and talent pool that needs a bigger client base than we can access.
- Our business processes and practices are somewhat out of date, and the new firm already has made the leap to new technologies and streamlined processes, so we can use their systems.

These are just a few common scenarios we encounter. Here is our perspective on each.

We Can Get More for Our Retirement Benefit From a Merger

Although this can be true, it is often not, at least the way we see it. What people really gain when merging is a belief that their retirement payout is more secure rather than much larger. Without getting into the financial structure of the merger (more on that in a later chapter), mergee partners basically get covered by the retirement plan of the mergor. The larger the firm, the more likely the retirement benefit is calculated based on partner compensation. Therefore, if your partner income goes up and you are with the firm for enough years to enjoy growth and profitability, then your retirement benefit could increase. However, the same axiom is true if you are still operating in your own firm, too.

Our experience is that insiders at your organization (your other partners) will pay you as much or more for your interest in the firm as an outside party. This occurs for one key reason: no change is required. Your people can continue doing exactly what they have been doing—working with the same staff and clients in the same environment. Also, your clients are being asked to change less, as well, promoting greater stability and retention. Although they might not be working with the same partner, they are still working with familiar faces and people who are already familiar with their businesses. So, although this comment is often made, it usually is less about the amount of money and more about the perception of actually receiving the money. This takes us to the next common merger rationale.

We Don't Believe That the Remaining Partners Have the Leadership Ability

We often hear this line of reasoning from senior partners or owners who are considering their exit strategies. They will give a quick rundown on each of the remaining partners and explain why they are not worthy to become firm leaders and take over once the senior owner departs. Many times, the net bottom line is that these other people just aren't enough like the departing senior owner.

It can be true that more of the remaining partners than not are possibly not ideal candidates to become the next CEO of the firm, and in some cases, no one is a good candidate for CEO succession. However, we often find one or more gems in the rough who just need some coaching, development, and direction to really blossom. It's a fact of life: most people need and appreciate some help as they are developing and growing into new roles. Unfortunately, another fact of life is that many senior CPA firm owners have neglected their own roles and responsibilities for identifying and nurturing new leaders who can assure the longevity of the firm and secure the payout of the retirement benefits. You may actually have the leaders you need waiting in the wings, but it will take some time for them to become ready for the new job. Now is the time to start that process.

We can't leave this topic without reiterating our most common quote, "The fish stinks at the head." If you are one of the great leaders of your company and you have built an organization devoid of other leaders, then that fact is really an indictment of your skills, not those of your people. The sad part of this story is that many CPAs start moving down this road to merger knowing that they have not been able to develop quality leaders and assuming all of the young leaders from the mergor firm are better suited for that important role. However, oftentimes, once the mergee owner becomes truly familiar with the new organization and the halo effect (the assumption that the mergor is void of the warts of the mergee) wears off, it is only then that he or she realizes the talent of his or her people. For leadership to flourish, it is not about magic. It's simply about building an organization that runs on processes, policies, roles, responsibilities, and accountability with the proper infrastructure. If you make that investment and consciously work on developing your people, you will likely find plenty of leaders to take over your firm and take it to the next level.

We Don't Believe That the Firm Will Stay Together After We Leave

This type of situation often occurs when a firm has warring factions or individuals who see the world so differently that they're constantly struggling with one another. In firms that have continued over time under those conditions, a managing partner usually has been able to defuse situations and keep the peace through his or her interpersonal interactions with the individuals involved. Essentially, the firm has been in a continual coping mode over the years, and as soon as the peacemaker leaves, a split is likely to occur (unless another equally and highly respected peacemaker appears on the scene).

Here's the rub: if the mergor firm recognizes that this level of dysfunction exists, it will definitely affect the deal or maybe scare them away altogether. Even if the mergor wants to go forward, it will split up the firm anyway. The mergor won't put up with the warring factions because a new leader will be named, and this one will be a ruler rather than a peacemaker. Issues that were debated in the old firm's partner meetings for years will have a quick resolution with two options: do what we just decided, or find a new job. So, all the Band-Aids and persuasion holding this firm together will not have added value to the merger. Rather, the merger will just put an end to it and the chips will fall where they may. Rest assured that, as these changes unfold, any negative outcomes or fallout will reconstruct the premerger deal. In the end, the mergee will only receive benefit for the real value brought to the mergor.

Most of the problems we are referring to here are due to a strategic mismatch of the objectives of the individual partners, with no way to resolve the situation without splitting up the firm. In many cases, mergees will turn to mergors to be the final arbitrator to resolve these disputes. This might include partners' conflict driven by objectives such as, at one extreme, pushing everyone to increase the take home income regardless of the effort required to the other extreme of partners being comfortable with their current earnings and just wanting a relaxed-pace, low-stress, minimal-requirements work environment and everything else in between.

We Have Some Partners Who Refuse to Be Held Accountable

Sometimes, out of a sense of frustration, CPA firm owners will often look to an upstream merger as a way to deal with problem partners who refuse to be held accountable at the firm. Merging to let someone else deal with these problems is like using hand grenades to go fishing. It is not only the wrong weapon, but it is far too much firepower for the job at hand.

The real issue is that the firm has neither a strategy the owners have all adopted nor a CEO who has the authority and ability to enforce accountability to that strategy. This is all facilitated through the use of the appropriate hierarchical structure, with defined roles and responsibilities for all partners, together with standard operating procedures that allow the CEO to carry out his or her duties and deal with intransigent partners. In short, deal with your own problems. As was previously stated, you won't get away with anything, financially speaking, by making someone else solve this for you. Once you have solved your problems, your firm will likely be a more appealing merger candidate (if you are still interested in moving in that direction), and you will be able to realize a greater personal value from the merger deal.

We Are Short on Talent, Either at the Junior Partner Level or the Next Tier Down

Again, a senior owner or a group of senior owners may feel that the firm has a serious enough talent gap that it needs to merge for self-preservation. We want to challenge you to take another, very close look at the people you have working for you. You may have all the talent you need, but they may just need more direction, training, support, shadowing, coaching, and so on than they've been getting. Take a look in the mirror while you're at it. If you truly don't have anyone who can step up to the plate, remember, the fish stinks at the head. The tone is set at the top. It's your firm and your people and your responsibility to develop them and move them along.

It also could be that your firm has never made the commitment to recruiting people or hiring enough people to ever catch up with capacity. Why? Because the mergee wants to take home more money than the firm can afford to pay out. Therefore, the owners are robbing the firm of critical infrastructure resources it needs. How do you think the mergor is obtaining the necessary staff? It is simple. The mergor is doing exactly what the mergee won't do on its own. If the mergor won't spend the money to develop the necessary talent

either, then it is looking at the mergee for staffing resources. If this is the case, the mergee should run like the wind because putting two self-destructive cultures together does not result in one supportive structure.

On the other hand, mergee owners could find themselves having to deal with a truly serious, strategic weakness that is facing their practice. The firm may have an active assurance service practice but be lacking any one partner who is passionate about it, leaving the firm vulnerable. Would this mergee benefit from a merger? Perhaps, but this challenge could be addressed through other means, as well. The key is to never run away from something; rather, run toward something. In this context, a merger shouldn't be a solution that allows you to walk away from the problems you have created in your practice but, rather, an option that allows you to take your well-run practice to a higher level.

Our Financial Results Are Not Particularly Shiny

This approach is something akin to going to see the wizard of Oz. We all want someone else to fix our problems—give us courage, a heart, a brain, or better profitability. A CPA or group of CPAs will look at the firm's bottom line and figure that the only way for them to get better is to join another, larger firm that already does better financially. The mergee assumes its only real problem is economy of scale. What it often doesn't consider is that the way the mergor is going to increase the bottom line of the mergee's firm is to demand partner performance at a level that the mergee owners were unwilling to produce on their own.

Besides the mergor forcing the partners of the mergee firm to do what they should have been doing all along, it also will extract some corporate or home office overhead in the process. So, had the mergee partners voluntarily held themselves to this same level of accountability, not only would they make more money, have more control, and enjoy a greater share of the new value being created, they would enjoy the extra overhead allocation, as well.

In the end, it surprises us how many firms merge thinking everything will stay the same but, magically, more money will flow to the partners. It also surprises us how many firms with poor profitability think that fact won't have a significant impact at the bargaining table. Here's the way we see it: you can make the necessary changes and investments yourself and enjoy a greater share of the wealth pie, or you can merge and the mergor will force you to make the same changes, with the greater share of wealth going to the existing partners of the mergor firm. Either way, the same changes are going to be required. The wizard is a fraud—you already have the heart, courage, and brain; you just have to decide how to use them.

We Have a Specialty Niche and Talent Pool That Requires a Bigger Client Base Than We Can Access

CPA firms often look at adding new services based on personal interests and desires of the owners. Sometimes, these services integrate nicely with existing offerings, markets, and clients—they have a synergistic fit. For example, a firm with a specialty in construction contractors may add project scheduling support, training, and consulting using Primavera or MS Project because it fits with what they are doing and for whom they're doing it.

Sometimes, however, these services don't have any synergistic value to them. Take the CPA firm that specializes in audits and reviews, many of them in the municipal and nonprofit sectors. Adding a litigation support practice to this firm may not make a lot of sense, at least in the short run. It's hard to see how it adds synergy to what the firm is already doing. We call this an "island" service because, in the overall scheme of things, it really sits out there by itself.

So, is this really a specialty niche that needs a bigger client base or an "island" service that should be discontinued in the first place? Before considering any merger for new service availability, a firm needs to have a clear strategic direction in place. Otherwise, everything or every new service looks like an opportunity, regardless of whether it is. Oftentimes, this issue is really less about needing a bigger client base and more about a confused growth strategy. This confused growth strategy is usually a result of firms allowing every partner to pick his or her own specialty area without consideration for client mix, synergy of services, and strategy. Taking this confused growth strategy and integrating it into a larger firm won't fix the problem—it will just compound it.

Just because one of your clients needs a unique service doesn't mean that someone in your firm should specialize in it. For some situations, consider using the general contractor model, wherein you help your clients find the people with solutions to their problems and oversee the process to be sure the needs actually get met within client expectations. Surveys of CPA firms' clients show that the clients don't expect the CPA to know everything or how to do everything, but they do expect the CPA to know where to get the answer to the question or have access to someone in their professional network who can help. The general contractor approach to client service helps firms manage client needs without requiring excessive specialization or overcommitting scarce resources.

Our Business Processes and Practices Are Somewhat Out of Date

Keeping up with technology is becoming more and more important in order to deliver timely, effective, and more efficient services to clients, and it continues to pose challenges to smaller firms. Consequently, some of them look at the opportunity to upgrade their technology as a mark on the plus side of the ledger when looking at mergers. It's true that if the mergor has good systems in place, the mergee will immediately gain some economies of operation. However, you shouldn't need to merge to have workable technology in this day and age. You may just need to plan and budget for your technology investment and set about implementing the technology plan.

Why Mergor Firms Might Be Looking for a Downstream Merger

Now let's take a look at this from a different angle: the point of view of the mergor. First, you need to ask yourself why you would want to take on the baggage of another firm rather than internally growing or developing the necessary talent yourself. As was previously

stated, the mergee is looking to the mergor to fix its problems, but what is interesting is that mergors also tend to look at the mergees to do the same. This is why mergers are often described in the following way. When we ask firms to describe the success of an acquisition or merger, this is a common response:

We have done several acquisitions and mergers, and they have worked out fine. For example, we recently merged in a firm that had a specialty niche like ours. We paid approximately \$1 for the revenues over 5 years and kept approximately 40 percent of the clients. Just a few years ago, the senior partner of the mergee firm finally retired, and that has really been a breath of fresh air. This guy caused significant problems around him—always wanting his clients to be treated his way, taken care of first, and so on. Now that he is gone, we can finally let go of the troublemaking manager who came with that firm (the retiring partner protected her and wouldn't let us fire her, no matter how abusive she was to other employees). All in all, now that we look back over the past 5 years, I think we have that merger behind us and are starting to move forward again.

This takes us back to the question with which we started. If this is a common story (and we can tell you it is), then why did the firm want to merge in another firm to gain access to its talent and client bases when, much of the time, the talent base wasn't as good as it looked and the client base wasn't either? We guess it comes from the “grass is greener” philosophy, wherein everyone assumes someone else doesn't have the same warts they do (and, certainly, the mergee will do everything possible to hide them).

Please understand us; we are not trying to be negative about mergers. We think they can be a great option for some firms (if the firms' partners' eyes are wide open) but we would challenge mergers with this point of view. Consider investing the same financial resources and partner and personnel time in developing your own firm's infrastructure to accomplish the same gains expected from the merger versus just defaulting to looking for a merger candidate. The problem is that most mergors look solely at the financial resources and assume that the unbillable partner and personnel time required trying to integrate the two firms is negligible. They often don't consider the disruption and dysfunction created by adding partners who are used to doing things their own way. Finally, mergors rarely envision the result of a merger to be even close to what reality seems to deliver (conflicts, terminations, client firings, and so on). So, once everyone takes off their rose-colored glasses, we are then poised to see the merger potential with the clarity of the light of day.

We have one more thought to share on this: if, every time you want to improve your firm, you default to looking to a merger candidate as your solution, why is investing more internally to expand on what you have built always viewed as a poor use of resources? Put another way, if everything you build internally is so average compared with options out in the marketplace, then maybe you should be looking into an upstream merger to solve your problems.

The following are a list of reasons we commonly encounter when someone wishes to grow through mergers, usually with smaller practices:

- We can acquire more market share more effectively by merging this firm in than if we used a marketing strategy-based approach to growth.

- We'd like to add some new services, or the mergee firm would be able to help us with a specialty niche.
- We need to prop up a marginal office or expand geographically, so we'll acquire a practice nearby.
- We are short on talented people, either at the junior partner level or the next tier down in the hierarchy of the firm, so we're acquiring this firm to get their talent.
- We have too many partners around the same age, and we don't think our junior partners have the leadership ability for the firm to continue over the long run, so we're merging to augment our partner group.
- We have some partners who refuse to be held accountable and function as a partner, so we're going to add some more owners to try to tip the voting scale so that we can make some governance changes.

We Can Acquire More Market Share More Effectively by Merging

It depends how you define *effectively*. You can, indeed, acquire market share quickly through mergers. Keep in mind that with every merger, you likely will end up

- paying \$0.75–\$1.00 for every dollar of revenue you acquire or some retirement benefit in line with that.
- initially getting some clients you don't want.
- inheriting the bad business practices of the mergee firm and its owners.
- trying to integrate a different culture and potentially somewhat different sets of values, which could water down the culture and values you currently hold dear.
- merging in one or more problematic staff or partner.
- incurring costs to integrate the mergee firm's systems with yours.
- spending yet more money to retrain the people from the mergee firm in your processes and procedures.

So, if you have a need for speed in your firm's growth, you can grow through mergers, as long as you recognize that the real cost of growth will be much more than the initial merger price or benefit would have led you to believe. On the other hand, you could spend a fraction of what it costs to merge with someone (yet still truckloads more than you probably presently are spending) for some targeted marketing and grow your practice very effectively yourself. It will just take you a little longer. By the way, if you can't grow your firm on your own, you have a bigger problem that you should be dealing with instead of committing resources to a merger. It may be time for some soul searching about why these conditions exist and then committing to doing something about them internally.

We'd Like to Add Some New Services, or the Mergee Firm Would Be Able to Help Us With a Specialty Niche

This often is a valid reason to merge a practice into your practice, as long as you keep the following caveats in mind. It can result in you jump-starting a new service offering by bringing an already established system on board. This is the "buy" portion of the traditional "make or buy" question that companies face in strategic decision making. Keep in mind

the fact that CPA firms often look at adding new services based on personal interests and desires of the owners. Sometimes, these services integrate nicely with existing offerings, markets, and clients—they have a synergistic fit. For example, a firm with a strong estate planning practice could potentially better serve and increase loyalty from that same clientele by offering wealth management services. However, sometimes, as was previously covered, adding some new services will only create a need to build an entirely different client base, which can be costly, inefficient, and an unprofitable use of scarce resources. Furthermore, developing a strong network with other professionals and niche CPA firms could be a better solution to this issue than a merger.

We Need to Prop Up a Marginal Office or Expand Geographically, So We'll Acquire a Practice Nearby

If you already have established an office somewhere away from your other locations, you could consider merging a firm into it as a means of propping it up and more quickly covering your fixed costs of doing business there. This could allow you to generate a sufficient book of business for that office and the partner and staff housed there. Again, though, you need to consider the potentially hidden costs of a merger that we covered earlier.

This is also a good strategy when it is very difficult to break into a community. We have found a strong sense of community in some cities and towns that drives a desire to do business with other locals. Although these businesses have no problem working with organizations that are owned by “outsiders,” they want some of the key decision makers in that local office to be long-term members of their community.

For firms that have strategies for expanding into rural areas and small towns, once again, merging might be the best strategy to obtain a presence because it might take 10 years to build that same presence on your own.

However, we don't feel right leaving this issue without circling back to the first point. If you have a marginal office and you are wondering if you should shut it down, be aware that merging in another firm is unfair to the mergee if you are not willing to take decisive action against those currently running that office. Adding good people to a bad management team does not fix the problem—it only makes it bigger. Our theme is clear throughout this material. Fix the problem, don't try to cover it up or “politic” it away.

We Are Short on Talented People, So We're Acquiring This Firm

Our profession is facing and will continue to face a shortage of talented, experienced staff, managers, and partners. As we have covered before, generally, the bottom line is that if you're looking for an experienced, 6–10-year person, hire an entry-level person today and really train him or her for 4–6 years (hopefully less).

Not wanting to take that long, some firms will use strategic mergers more for the purpose of getting talented staff than for acquiring the client base. We've seen examples when the acquiring firm simply wanted the staff because they fit its industry and service offering niches. However, don't assume this kind of merger returns the same price and benefits as one that offers both a quality staff and client base.

Some firms might find themselves in a situation in which they truly have a serious, strategic weakness facing the practice or a seemingly one-time opportunity of which they can take advantage, and by merging in another firm with an abundance of talented staff, that crisis can be avoided. In this case, the mergor is likely to run off most of the mergee's clients because the mergor is just trying to staff the strategic clients they already have. The mergee needs to understand this plan and how this choice will impact the future benefits of the deal. Also, the mergee needs to consider the fact that the mergor is in this situation in the first place. In other words, is the mergor doing what needs to be done to avert this from happening again, or is the same crisis likely to occur two or three years from now because the real issue is that the mergor just doesn't understand what it takes to recruit, train, and develop people at a pace to respond to capacity needs? Taking this a step further, occasionally when the mergor merges in a firm to gain access to more staff, it finds out that very few of the staff stay around (either because the staff don't want to stay or the mergor runs them off due to their poor retention practices). Once again, this occurrence can easily affect the deal either party finally receives.

One more word of warning—although instant access to talented staff is terrific, if that staff is not

- used to operating in a culture similar to that of the mergor,
- accustomed to functioning within defined standard operating procedures,
- comfortable with performance-based pay systems, or
- supportive of developing those around them,

then that staff could quickly turn from a talented, productive group to a negative virus affecting the throughput of the entire firm. As accountants, we far too often look at these decisions primarily from a financial perspective or as statistics-based decisions rather than what they more often are—people and culture decisions.

We Have Too Many Partners around the Same Age, and We Don't Think Our Junior Partners Have the Leadership Ability for the Firm to Continue over the Long Run

As we discussed above, we often hear this line of reasoning. In addition to the issues we raised above for firms with this perception and looking for an upstream merger, consider the additional complications for firms looking for a downstream merger for this reason.

It can be true that more of the remaining partners than not are not ideal candidates to become the next CEO of the firm, and in some cases, no one is a good candidate for CEO succession. However, we often find one or more gems in the rough who just need some coaching, development, and direction to really blossom. It's a fact of life: most people need and appreciate some help as they are developing and growing into new roles. Unfortunately, another fact of life is that many senior CPA firm owners have neglected their own roles and responsibilities for identifying and nurturing new leaders who can assure the longevity of the firm and secure the payout of the retirement benefits. You may actually have the leaders you need waiting in the wings, but it will take some time for them to become ready for the new job. Now is the time to start that process.

Bringing in partners from the outside certainly can work, but those partners are just as likely to have as many flaws as the people the senior owners just decided to overlook. Even worse, these new partners may be incredible superstars trying to work within a “building a village,” or operator, model and will function like fish out of water. As soon as they have enough influence, they will shift the firm to the “eat what you kill,” or superstar, model with which they are familiar and potentially destroy the long-term viability of the merger. It is just never as easy as it looks. Please note that we acknowledge that this kind of merger can and does work, but it will be the exception rather than the rule. The partners being brought in to take over as the senior partners will, almost without exception, try to make the merger firm look like that of the mergee as soon as the senior partners are no longer around. If the mergee firm is well run and has a very similar style of governance, culture, accountability, processes, and so on, then this could be a great move. If not, don’t set your firm up for disaster by taking this bold of a step. Your best bet is to develop leaders from within. If you can’t develop leaders from within, then, as we have said so many times before, you have a bigger problem, and you should be addressing how to solve it instead of complicating this issue with a merger. At the end of the day, if the merger firm can’t develop leaders, adding another firm won’t change this, it will only compound the firm’s problems.

We Have Some Partners Who Refuse to Be Held Accountable

As we discussed above, this is another situation you should be taking care of regardless of merger opportunities. Bringing more new faces into the fray will only muddy the waters and you’ll have that many more frustrated partners with whom you must deal. If you have an overall strategy in place, you should expect all of the present owners to get in line and support it. If they don’t, cut them from the fold. If you don’t have this capability within your current governance structure, then, in a friendly way, decide how to split up this entity and the clients so that what emerges are some firms that can operate in this fashion. If you can’t do that, then merge upstream into a firm that has already addressed this issue. Know that if you can’t fire a partner without an act of Congress being passed, you are positioned to fail. As you grow, this situation will only become worse, not better.

The CEO of the firm needs to have the authority to manage the performance of each partner, and each partner needs to have some portion of his or her pay at risk to provide an incentive to do what the firm requires of him or her to achieve the strategy. This is all facilitated through the use of the appropriate hierarchical structure, with defined roles and responsibilities for all partners, together with standard operating procedures that allow the CEO to carry out his or her duties and deal with intransigent partners. In short, you shouldn’t be doing a merger in order to deal with partners who don’t want to go along with the firm’s plan and direction.

Contact Potential Merger Candidates and Discuss a Potential Merger

Whether you have already done your own mental screening and have some prospects in mind who could be possible merger candidates or you've just now gone through the factors we covered previously in this chapter, it's time to contact some firms. How do you go about starting this process? Following are some tips for you as you take this crucial step.

Finding a Potential CPA Firm Candidate

If your firm is looking for a merger candidate and you don't personally know or have in mind an owner to contact, then you have multiple choices to consider. In no particular order, they include the following:

- Contacting a CPA firm broker
- Actively utilizing your network
- Direct advertising

The key here is whether you are the mergor or the mergee. If you are the mergor, the danger of confidentiality is much less of a concern to you. Therefore, mergees have to be more protective than mergors about reaching out to the marketplace. For example, if the client of a mergor finds out his or her CPA firm is looking to expand and acquire another CPA practice, the client would either think nothing about this or feel good about the success that his or her CPA firm is enjoying. When staff find out, although this could cause some trepidation, the more likely response would be confidence and security in knowing that the firm they work for will be the same but larger. This news also might spark excitement about potential opportunities from growth.

On the other hand, the mergee is more than likely in the same position as the selling firm we covered in the last chapter. Neither clients nor staff will likely take this news well. So, the mergee would probably consider the CPA firm broker, then potential direct advertising, but be careful about actively utilizing its network. With this in mind, here is a little more definition of each approach:

- *Brokers.* Obviously, just as business brokers are in the corporate world, in the CPA community, CPA firm consultants fill this void. Normally, a firm would contact one of these consultants and let him or her know it is in the acquisition or merger market. The next step is typically to either pay the consultant a retainer or pay him or her to come out and familiarize him or herself with the mergor firm's operation. During this initial phase, the consultant usually
 - either helps the mergor firm define an acquisition strategy or becomes familiar with the one that has already been developed.
 - constructs a list of negotiating points (from deal breakers to those with extreme flexibility).
 - determines what the characteristics of the target (mergee) firm should look like to develop a target firm profile.

- ascertains the size of the market to solicit (geographic limitations, numbers of firms, and so on).
- calls candidates he or she knows who might be a good fit, puts together a marketing campaign to solicit firms that seemingly meet the profile, and invites candidates to call for a confidential screening discussion.

The fees for this service vary, with retainers that start at approximately \$5,000 and go up based on the amount of work that needs to be done up front. In addition, a percentage (approximately 3 percent to 10 percent) is commonly charged at the completion of the acquisition or merger. As with typical commercial business brokers, the smaller or larger the deal, the more the fees are specifically negotiated. When you look at the entire deal, if it is a small \$500,000 acquisition, consultants will shy away from percentages and set fixed fees (perhaps approximately \$50,000), and when the deal looks like the percentages will generate too high a fee, the merger firms will shy away from the percentages and negotiate fee ceilings, as well.

The disadvantage of bringing in a consultant is the money, but the advantages are as follows:

- He or she is familiar with the profession and can quickly rule out firms outside the established profile.
- He or she can create an active and anonymous marketing campaign to try to reach a number of firms that otherwise would have been missed through an informal contact network.
- Consultants can prequalify the candidate firms to minimize first round review evaluations.
- By having a consultant as a middleman, you can keep the conversations with the target firms more on point and impersonal.
- By having a consultant as a middleman, certain information can more easily be withheld. Often, when partners are confronted by target firms for semiconfidential information, they might feel obligated to provide specifics, but the consultants will provide industry generalizations.
- Consultants can be gatekeepers who provide another level of protection against tire kickers or firms that are using this invitation to do some competitive intelligence work.
- Consultants can provide an objective view of the two firms in question and offer insights regarding potential clashes in culture, partner expectations, internal organization, systems, and so on.

All in all, because the soft costs of completing a transaction like this can be from one to two times the hard costs, bringing in an outsider can improve the chances of success, as well as the seamlessness of the integration. Involving a consultant might actually be the most prudent use of your money.

- *Actively utilize your network.* This approach is simple and straightforward. You call people you know to give you recommendations of firms to contact. What you are looking for here is an “in.” It is a lot easier to start a conversation with an owner

you don't know by dropping the name of someone you both know, such as, "I was talking with Sam last week about our plans to expand into your area, and he thought we should talk and see if there was a win-win opportunity for both of us." This network goes beyond just other CPAs you know; it can include other professionals, such as your attorney, insurance agent, investment broker, and so on. As we just stated, if you are the merger, news leaking that your firm is looking at expansion opportunities isn't really bad press. However, if you are going to take this kind of aggressive approach at finding a merger candidate, you should let your people know. Remember, the grapevine is faster than management ever expects, and the interpretations from the news are often far more negative than their reality. So, manage the reaction by communicating in advance and silencing the grapevine.

Another source for possible merger candidates is through your local association executives and contacts. For example, people working at your state CPA society or, even better, your local chapter of that state society, likely will have insight into firms you could contact.

- *Direct advertising.* This is a third alternative, but because it has the word *advertising* in it, many are scared away. This is a simple tool. You can put together postcards, put an ad in your state CPA society magazine or local paper, or activate any number of media to solicit interest. Certainly, you would want to promise anonymity to those inquiring about the advertisement. You can do this by hiring an outsider, such as an attorney, a consultant you use, and so on, to screen the contacts and ensure the information stays private until nondisclosure agreements are signed.

Generally, the more direct the approach, the better. For example, we like using postcards for direct marketing. Simply ask if anyone is looking for another firm to be their succession plan, and give a general description of your practice and what you are looking for. Take the same approach if you are looking for an upstream merger, and emphasize that you are looking for a firm to be your succession plan. At this point, the potential candidate should be instructed about whom to contact, and if you are the mergee, you should definitely have a screener employed to protect your anonymity. You also can consider trying to find a potential merger candidate through one of the emerging online services that list CPA firms interested in buying or merging.

You can usually buy lists of CPA firms from your local state CPA society and from the AICPA through CPA2Biz. These are direct mail lists, and are they controlled so that purchasers can't buy a list and reuse it over and over. Although you typically can't specify the size of a firm, such as \$1 million in revenues, you can get to the same place by looking at firms with a certain number of members in that organization. This is not an exact science; we are just looking for "in the general area of" possibilities. For example, a firm with 2–5 members of the AICPA is likely to be in the ballpark. Consider \$100,000 in revenue per full-time equivalent as a low average for this simple calculation. So, if 2 people are members of the AICPA, the firm probably has 4–6 total people, which would extrapolate to total revenues from

\$500,000 to \$800,000. If a firm has 5 members of the AICPA, it probably has 9–12 full-time equivalents (some administrative staff, a couple people who are not yet CPAs, and so on) and, therefore, has total revenues ranging from approximately \$1 million to \$1.5 million.

The point is that the kind of information you need in order to find likely candidates is readily available. You just have to put together a program to utilize it. Make sure your program protects those who inquire, or it won't have a chance to get off the ground.

Initial Contact and Discussion

Now that you have identified some firms to talk to, the first discussion you have with a prospect should probably be a brief phone call with each of the managing partners or CEOs of the firms at the top of your list. In this first phone call, you can briefly indicate that you're looking at opportunities from merging with another firm, either upstream or downstream (whichever is appropriate), and ask them if they'd be interested in talking about a possible combination of the firms. It is important to clarify whether you are looking for a firm to merge into or a firm that will want to merge into yours. As we described in our definitions at the beginning of this chapter, a substantial difference exists between positioning your firm as the controlling firm or the mergee or acquired firm.

Of course, you should let them know that this discussion is extremely confidential and that you're contacting them because you feel this could be a good choice for them, as well as for your people and clients. You also should tell them that you are considering other firms, as well, but that you wanted to give their firm an opportunity to consider the deal. (More on the notion of having multiple firms looking at the same time follows.)

At this point, the potential mergee firm may ask you about the size of your business, your staffing situation, and your timing, but it's usually a pretty general question, with a general answer required. For example, if asked about the business, you might tell the prospect your revenues, service split, and personnel (for example, "We are a \$2 million dollar firm with 3 partners, 15 full-time equivalents [including partners], and a service split that is roughly 40 percent, 40 percent, and 20 percent among assurance, tax, and consulting work."). This is about all of the information necessary to start the ball rolling. If there is enough interest to talk further, then we need to raise the ante of confidentiality with a non-disclosure agreement.

The Rejection

It's probable that several firms you contact will not be interested in a merger with your practice, and the response you receive during, or some time shortly after, the first call will be a polite "Thanks, but no thanks." Keep in mind that a variety of factors could lead to this result. We've already covered a list of them in the introduction of this chapter. The other firm, when thinking about your firm even at this early stage (based on its perception of you and your practice, your client mix, staff capability, and so on) just doesn't think this combination is a good fit. This could be based on where it is now, its plans for the future, and so on. It could be that it, like so many other firms around North America, is understaffed and overworked, and pursuing this idea today is just bad timing. If you are the mergee, it might

be that the mergor may not have the physical office space to accommodate taking on more staff to help handle the work, and it is not interested in working out of two locations. The mergor might be dealing with its own internal or succession problems and can't add more complexity to its situation until it has cleaned up its own house. So, its polite refusal may have far more to do with its lack of planning than the reality of your practice.

On the other hand, if you haven't properly positioned your firm for merger, it could be looking at the challenges of such a transaction. For example, it may be thinking about the problems it will encounter when taking over a superstar practice because it is committed to using an operator model of business. It could be that you have built a client base with too many "C" level clients who inappropriately expect a top partner's attention. It might be perceived that you have a staff roster that includes personnel who have never been developed the way they should have been. Given this view, the potential merger candidate's refusal may be an absolute reflection on you and your practice.

However, it really doesn't matter. At this point, whatever you have is all you have to offer. It is what it is, and you need to take this rejection in stride and mount a concerted effort to implement your merger strategy by contacting all of your likely candidates more or less simultaneously.

Subsequent Discussions

Many times, this initial telephone call will be all that's needed to go to the next step. The managing partner or CEO of the other firm will be interested in taking a look and will ask you for some more information to continue the conceptual discussions. We'll cover the provision of that information in a moment. In other cases, the first call will lead to breakfast, lunch, or other off-site meetings with one or more of the owners of that firm to talk briefly about the business, staff, and preliminary thoughts regarding what both parties might be looking for in a deal like this. In turn, that meeting can lead to information sharing and further discussion. We'll cover the information sharing and documentation subsequently.

Conducting Simultaneous Discussions With Prospects

It is important to put the firm in play with several prospects at the same time, whether you are the mergor or mergee. This is because you'll find that some firms' leaders will take a look and then have to talk with the rest of their owners before they decide to move to the next step. Other owners will go through a couple more steps up front before they give this serious consideration. Because different people have different approaches to the investigation process of merging in a firm, you'll want to keep multiple parties in play to keep the process moving, or you will just find this process frustrating as you move from one firm to the next while time ticks away.

The question is are you interested in a merger, or are you just interested in assessing your options? We are assuming you are interested in a merger. If this is the case, take on this project like you mean it, and do not dabble in hopes that something might come up.

Many firms are not looking for a merger candidate as much as they are looking at one or two very specific merger candidates. Obviously, in this case, you just pursue those one or

two firms that you believe will have a strategic impact on your firm. If the doors close to a merger with those two firms, then a merger is taken off the table as an option, and the firm should start pursuing other growth or development activities.

Consider that a lot of firms are in the marketplace that will be looking to acquisition or merger in the next 10 years. If a merger is your strategy, make a real run at it so you can decide if this approach is a viable strategy to help you achieve your objectives. If it isn't, then you want to know that, too, in a reasonable amount of time. This way, you limit the duration that your firm is in limbo. If merger is the chosen strategy because you have found the right candidate, great! However, if you have played your merger hand and not found what you are looking for, you need to move on. As long as the firm's owners think a merger candidate is going to appear through the mist, the firm will just spin in this area, and minimal resources will be dedicated to generating the growth or staffing desired. The longer you wait in this spinning mode, the more time will pass that you could have used to address these issues internally. As the clock continues to tick, if you are like many firms, you will eventually find yourself in a position where you are losing the luxury of an internal solution because of the time this approach takes, thereby pushing the firm to consider more marginal merger candidates. So, regardless of what you hope to gain from a merger, if this is the approach you have chosen, vigorously investigate your options, and if they don't pan out, move on to making something happen yourself. Don't let the possibility of merger become a strategic albatross around the firm's neck.

Here is another issue, and it is very psychological for you. Each time you get rejected, you could become more insecure about the worth of your practice, and this is a bad situation. If you thought every person you called would be interested in your practice, you were dreaming in the first place. We have covered a lot of reasons why your firm could be the best in the world for you, but based on compatibility or just plain timing for the other firm, your deal won't make sense. So, you need to plan on contacting five or more firms to have a chance at one possessing any real interest (and this ratio assumes you know these firms and have a relationship with the partners in the first place). If the firms you are contacting are more of a cold call on your part, then the ratio decreases even further in regard finding a likely candidate. You need to have multiple firms in process simultaneously all the time. As soon as one firm falls out, add another. This way, you will maintain a much more positive attitude, which minimizes the nonverbal communication of desperation on your part and will likely result in a better and quicker deal for you and your firm.

Also, when you let firms know that there are other possible candidates, if the deal looks like it would fit within their strategy, they will be inclined to move more quickly and negotiate a better deal with you in order to beat out the other candidates.

Timing

When should you to kick off these discussions? It all depends. For most smaller practices that experience the thrill of busy season, it makes more sense for both parties to start these discussions four or five months before busy season or right after it. Trying to make something like this happen too close to tax season usually ends badly. An interested party may walk away, or the firm looking for a merger partner might greatly discount the practice in

order to get the deal done before tax season. Rushing the front end, compromising client communications, poor handling of files, harried introductions to the new firm, underserving transitioned clients because of the chaos, and so on all point to you losing value, which could affect your ownership stake, retirement benefits, and compensation in the new firm.

For Prospective Merger Candidates Interested in Pursuing Discussions

Once you've received an indication of interest from your prospects, it's time to go to the next step in disclosure and discussion with them. You will each be asking for more specific information about the other practice as you continue your discussions.

Prepare a Nondisclosure Agreement for Prospective Merger Candidates to Sign

Just as you would advise your clients who are thinking about selling a business to obtain a nondisclosure agreement before sharing critical information with possible competitors, you should do this for your business, as well. This agreement limits the prospective candidate's use of the information you will be providing him or her for his or her evaluation of this opportunity. It restricts him or her from discussing your information with others, and it requires him or her to destroy or return any documents you have provided. We've seen these documents run from approximately 2 pages to more than 10 pages in length, depending on the attorneys drafting them. Use whatever your attorney advises for your situation. Both sides should expect the same protection, so it is probably easiest to draft one agreement with both parties agreeing to the same conditions. If you'd like to take a look at a short but practical agreement that was included in the *Management of an Accounting Practice Handbook*, you can see a copy in appendix B, "Sample Mutual Confidentiality Agreement" in chapter 4. Once again, we want to make this clear: we are not suggesting you use this sample agreement. We are suggesting that you pay your attorney to draw one up for your firm. This is simply an example of one we have used when working with our clients.

One word of warning if you are the mergee: just because you have a signed nondisclosure agreement, that doesn't mean you are protected. You need to work through the merger process as focused as if a ticking bomb will go off if your deal isn't completed in three or four months. Your ability, or better put, your desire to prosecute if someone violates their nondisclosure agreement is tenuous at best. Fortunately, we work in a very ethical profession, which gives us more protection than normal, but there will be people who have signed this agreement who will talk openly about your situation. The results of this talk are (1) you will likely never know, so you will have no way to assess the damage; (2) even if you do know, unless the damage was significant and grossly negligent, getting recourse is difficult through our court system; and (3) once the news hits the street about you looking to merge upstream, some damage may be done as word filters back to staff and clients. This is not as dangerous a situation in a merger as with a sale because this is not about your departure but, rather, a strategy for change. So, although your clients are not likely to jump ship at hearing such news, some of your staff might. This kind of loss could be devastating to your merger possibilities, as well as place hardships on you; your partners, if you have any; and the remaining staff, if you decide to continue as you are.

Provide Prospective Merger Candidates With a High Level Summary of Practice Statistics (and Obtain Similar Information From Them)

To allow your prospects to begin to evaluate the desirability of merging your practice in with theirs or vice versa, you'll need to provide them some additional, more detailed information. The further you go in discussions with a candidate, the more detailed information you each will likely ask for. However, we've seen practices with up to \$2 million in revenues merge together with hardly any details. When these occur, and they are rare, they have the following common themes:

1. The mergor firm has never done this before, and it is about to make one of the biggest mistakes of its existence because it thinks all CPA firms are alike.
2. The mergor firm is looking for a strategic advantage it feels this merger will provide, and the details of the deal are not as important as other intangible factors of which you are not aware.
3. The deal is so good for the mergor firm that it doesn't care what the details are, and it wants to lock this down before you realize the real value of what you have to offer.

The bottom line is that most of the time, when the mergee or mergor CPA firm is asking a lot of questions and wanting more detailed information, it's a good sign that the deal is on the right track. It means both sides are taking the merger process seriously and trying to make sure the two firms are a good fit. Consequently, both sides will want to be sure that there's some economic potential in the deal, that the integration of the clients and staff makes sense given the mergor firm's overall direction, and that the nature of the practice and business model make sense. It may not require piles of paperwork for either side to review to make a decision. So, the first tip here is to start at a higher level of summary and gradually work your way down to as much detail as is necessary to make a favorable deal. Don't just come in and dump every detail of your business on your potential candidates. Keep the conversation going, give them information in consumable pieces, and regularly dialogue about what information is needed next. This will help you understand who is still interested and who is likely falling out. Someone falling out of the process is not bad news; it is just reality. The sooner you know this, the sooner you can find someone else to put in the pipeline so that you are always working multiple potential merger candidates. The bottom line with a merger is that, in a sense, both firms are selling and both firms are buying. Therefore, everyone has a need for the same type of information. If one of the parties is in too big of a hurry and wants to gloss over this level of detail, then they either aren't really interested and are just trying to find out whatever they can or there is something wrong and they want to move fast before the problems are discovered. Either way, be cautious if this behavior arises.

Staff summary. Given our last decade of staffing shortages, it's no surprise that many mergor firms are as interested, or more, in your staff as they are in your clients. Consequently, you need to provide them with a brief summary of the people in your firm who might be coming with the practice. List the staff, charge rates, pay rates, their education, experience in public accounting, and other relevant information. It doesn't have

to be a full-blown resume on each person or even what we refer to as a *summary resume*. A simple chart or table will provide enough information to create some discussion. It is meant to give prospects an overview of what type of people they should gain. At the same time, the mergee should look closely at the mergor's staffing; years of experience; rate of pay; charge rates; and, particularly, the hours it's working and charging. If you're merging to get some more technical help in assurance services, does it really look like the mergor has the capacity to provide it, or will your clients become the *personae non gratie* of the practice? Joining an already overwhelmed, undermanaged firm *will* not solve this type of problem for you. A sample format is available for you in appendix C, "Sample Staff Listing" in chapter 4.

Practice summary. You'll each want to know the size of each other's business, and you need to understand the relative profitability of each firm. You'll be looking at total production, net revenues (production net of write-downs), and estimating costs to service the clients, as well as potential synergies and economies of scale. This all factors in when determining how much ownership interest will be assigned to your portion of the business. (More on that later.)

Practice statistics that both of you will likely need to get the ball rolling would include the gross production by category of work (audits, reviews, tax, and so on) and the net amount billed or realized by category. It's also helpful to provide and obtain a listing of major client groups and approximate annual fees for each of them. What we mean here is that you should summarize the aggregate annual revenues to you from each group of related clients. For example, if you do work for a family that has four brothers, each of their personal returns would be included in the client grouping summary, together with all fees associated with their various entities' tax and accounting work. This gives both parties a better idea of the nature of the work you're each doing. We recommend omitting the actual client names from the group listing at this stage of the discussion. Most of this information should be easily summarized from whatever time and billing system you each are using. In appendix D, "Sample Practice Summary for a Firm That is Being Sold" in chapter 4, we included a sample of an information summary used for a sale of a small practice.

If Further Discussions Are Warranted, Provide and Obtain More Detail

Assuming that everyone is still gung-ho (after the information previously discussed has been reviewed) and wants to take the discussions to the next level, both of you will likely ask for more detail on staff, clients, services, and revenues. For staff, you each may need to do a brief summary resume for each staff person (for the mergor, just key people) that embellishes the information from the table you provided earlier. However, for smaller practices, the missing information often is filled in through personal conversations between the two parties.

You both may ask for more information on the client groupings you provided during the first pass in the practice summary referred to above. This could be something as simple as an Excel spreadsheet or a system-generated report that shows the individuals and entities included in each client grouping, together with hours spent on them, total production or charges, write-ups and write-downs, and net revenue per client.

You both also may want to see a detail run of each firm's books of business that shows, for the last year or current year to date, or both, all clients listed out individually, with hours, total charges, write-ups and write-downs, and net billings for each. Usually, you won't get to this level of disclosure unless you are in the final stages of the deal. Just be sure you have a signed nondisclosure agreement before you release the information.

Continue Discussions Through to Closure

As you continue to share information with prospects, you'll be in a steady dialogue with them, asking and answering questions and explaining to each other what will be different from the last full year compared with the current year to date and the next fiscal year of the practice. For example, if in the last full year, your firm provided monthly write-up or book-keeping services to a client group that had low realization due to problems with pricing or the client, you will want the prospects to know what you have done to resolve that. Similarly, if you took over the accounting for a new client last year and generated significant, unexpected fees from cleaning up messes left by his or her former accountants, you'll want the prospect to know that the fees for that client group most likely will be somewhat less this year than they were last year. Also, if a client group has left your firm or been terminated, you will want to disclose that, as well, or better yet, just leave these clients off your reports in the first place. Of course, you'll be looking for this type of information from them, as well.

At some point, prospects will start bowing out during any one of these phases as soon as they realize that they can't find a way for the deal to work or they have gathered all of the intelligence they want from this investigation. Unfortunately, some firms are vultures. They will look at your information; gather as much data as they can; and, when the merger of your practice is publically announced, contact key clients who you are trying to transition to the merger firm. It can easily be argued that this is not a violation of the nondisclosure agreement because, in many communities, firms already know your top clients (because they play golf with them, go to church with them, and so on). That is why you need to be ready to continue working through this as if time is off the essence (mostly because it is—more on this in a minute).

On the other hand, rather than bow out, one or more of your prospects might make you a tentative offer. Obviously, unless they give you exactly what you are asking, you have just begun the negotiation process. Once again, keep every other prospect in the pipeline moving because the negotiation process can come to a screeching halt in an instant.

Merger Negotiation and Documents

Once you've made it this far, you should consider some key topics that need to be covered to consummate this deal. Here are a few steps we think you should consider.

First of all, without getting into the details of determining the value one would receive from a merger, it is typically handled like a pooling of interests. Although situations vary, causing unique deals to be made every day, generally, the mergee partners gain access to a range of benefits based on the value of the deal. So, besides working out the equity,

compensation, retirement perks, and other benefits (to be covered in chapter 9), some of the critical issues to resolve at this stage—in no particular order—are the following:

- Due diligence that the shared information is correct.
- The opt out clause.
- Who is going to be a partner?
- Who gets new clients acquired during the one year probationary period if demerger occurs?
- Handling of clients and staff who choose to stay with the other firm if demerger occurs.
- Employment agreements to be executed if continuation is selected after the one year probationary period is over.
- Organizational structure or chart of the merged firm.
- Roles and responsibilities of the mergee partners.
- Type of work to be performed by the mergee partners.
- Ownership interests of the mergee partners.
- Voting rights of the mergee partners.
- Implications of excessive owners' contributions.
- Termination process and the rights of the mergee partners.
- Voluntary withdrawal and the rights of the mergee partners.
- Termination process of the mergee clients.
- Minimum vesting hurdles for firm retirement benefits.
- How an upstream merger or sale of the merger firm affects the mergee partners and any outstanding requirements to fulfill at that time.
- Initial salaries or compensation versus falling into the standard partner compensation plan.
- Handling of the fixed assets, work in process, receivables, and payables of the mergee firm.
- Handling of the office lease or owned building of the mergee firm.
- Required capital contribution and timing, if required.
- Mergee partners' access to draws.
- Rights of the mergee partners with respect to perks, such as business entertainment expenses, automobiles, clubs, and so on.
- Selection of the managing partner.
- Rights of the retired partners of the mergee firm if they still want to work.
- Tax obligations not paid at the time of the merger and how those will be handled post-merger.
- Vacation, sick, and paid time off benefits for mergee partners and staff.

We are not going to spend a lot of time on any of these points because many of them are self-explanatory. With many of these, we will just be asking a question or two to get you thinking about how you want to handle them.

Due Diligence That the Shared Information Is Correct

This issue is straightforward enough. Before you jump into the final execution of a merger, you want the right to go in and look at specific backup information to ensure the deal you are putting together is based on approximate fact. If there is one thing we don't need to tell this group, it is how to approach a due diligence audit. Both parties should have a right to access specific backup information so that they can be comfortable with the firm they are about to join.

The Opt Out Clause

Probably the most significant clause you can create is an opt out clause. A year is a reasonable amount of time for the mergee and mergor partners and staff to get to know each other and validate that this marriage is one they want to consummate. If the term is much shorter, you don't get to go through a full business cycle together. If it is much longer, the merged firm is putting off efficiencies that could be gained through final integration.

A key thing to understand about an opt out clause is that from the first day, the two firms act as if there is no clause. This is not meant to set up a situation in which both firms do their own thing for a year to see if they like each other. Rather, everything is conducted as if the merger was final, including the following:

- Announcements to clients and referral sources of both the mergee and mergor
- Utilizing the mergor firm's systems
- Converting to the mergor firm's processes
- Following the mergor firm's policies and procedures
- Introducing specialized talent of both the mergee and mergor to firm clients
- Indoctrination into the mergor firm's evaluation and performance management processes

So, if this is the case, you might be wondering about the purpose of the opt out clause or what final steps the merged firm would be waiting on completing. Steps that the merged firm would be waiting to complete would be steps such as totally transferring client responsibility to another partner (from a mergee to mergor partner or vice versa), firing clients, shifting major priorities (such as having a partner move from a generalist to a specialist role within the firm), closing down the physical location of the mergee, and so on.

Whether the previously mentioned points are examples of those that make sense holding off on implementing is not the point. The point is that a couple of key changes logically wait until the opt out clause is waived. Nothing is saying that both parties can't agree at an earlier waiver date, but we wouldn't make it too soon, maybe any time after six months. You want people to work together long enough to see the warts, and you want them to work together long enough to see beyond the halo or white knight effect we tend to grant people we don't know well before we realize that they are human like everyone else.

As for the opt out clause, this just simply allows both the mergee and mergor to raise their hand and say, "This isn't what I signed up for. I would like to go back to the way it was." This creates a friendly demerger, one with which both sides usually agree, and establishes a road map that the break up will follow. Here is a recent example of an opt out clause we pulled from one of our client's recent letters of understanding:

The merger of Reeb, PC with Winters and Winters PLLC will have a one-year opt-out clause. This means that either partner or partner group (Bill, or Stan and Steve) can elect to return the firms back to their pre-merger status. Bill's old clients will be assigned back to his firm, and Stan's and Steve's old clients will be assigned back to W&W. New clients originating through Bill's contacts only during the period starting from the time of merger ending at the date of the decision to demerge will be assigned to Bill and taken at no charge. All other clients not specifically identified as originating through Bill's contacts only or through joint contacts of Bill and Stan or Bill and Steve will remain with W&W at no charge. After this client division list has been completed, any client that chooses to remain with other than the firm they were assigned will be charged to their firm of choice at a rate of either 150% of the last 12 months' billings or 150% of the average of the last three years' billings, whichever is lower.

At any point in time during this one-year opt-out period, should all of the partners agree to revoke the opt-out privileges and commit to such in writing, this clause will be voided for the purposes of this letter agreement. This will allow the merged firm to take more permanent steps regarding book of business management, assigning client accounts, etc.

Who Is Going to Be a Partner?

A basic issue in the deal process is who will become an equity partner in the merged firm. For those who were partners in the mergee firm and were not approved as partners in the mergor firm, some questions might include the following:

- How am I viewed?
- What is the process for me to become a partner in the merged firm?
- Over what time frame would it be reasonable to expect this to happen?
- Would I be a nonequity, nonvoting partner in the meantime or a director or manager?
- How would I stack up against the current nonequity partner candidates in the mergor firm?

These are issues that have to be addressed, or you can expect fallout from key people during the opt out period. By addressing these issues up front, you have a much better chance of effective damage control and of retaining those you would like to have as future partners.

Who Gets New Clients During the One Year Probationary Period if Demerger Occurs?

This question is self-explanatory. The issue is just answering it because a number of situations need to be addressed. A few scenarios that come to mind are a new client being brought in by

- the mergor firm and handed to a mergee partner to manage.
- the mergee firm and handed to a mergor partner to manage.
- the mergee firm and handed to a mergee partner to manage.

- the mergor firm and handed to a mergor partner to manage.
- a combination of work from mergee and mergor partners no matter who manages them.

Many would say that this is easy to resolve: whoever brings in the client gets to take him or her with them if the opt out clause is enacted. However, in many cases, that new client might not have come to that partner had the merged firm or the resources of either the mergee or mergor not been part of the solution. You have two issues to resolve. The first is when can a new client of the firm go with either the mergee or mergor with no price concession if a split occurs? However, you have to deal with the counter of this question, as well as the fee. When can the client go with the mergee or mergor firm with a price concession, and what is that concession? For example, if a mergor partner brings in new client because of the special industry knowledge of a mergee partner and that client wants to stay with the mergee partner upon separation, what compensation should the mergee pay the mergor for that business? We like 150 percent of one year's billed revenues because we think there should be a premium for this kind of cross-firm business generation. Then again, the amount is not as important as just making sure you address these kinds of contingencies.

Handling of Clients and Staff Who Choose to Stay With the Other Firm if Demerger Occurs

This is closely related to the issue that we just covered, but rather than being about the new clients who came to the merged firm during the one year opt out period, it involves those long time clients and staff who feel they found a better home working with the other firm.

Generally, we like to see two times the annual salary for staff and two times the annual revenue for clients. Why do we see these higher ratios here? Because these were “assets” of the firm prior to merger versus assets acquired post-merger. In our opinion, they should have a higher value or penalty for taking them.

Employment Agreements to Be Executed if Continuation is Selected After the One Year Probationary Period Is Over

This is simply tying up the loose ends by execution of any employment or partner agreements by the partners. As was previously stated, we have seen firms that operate with many partially signed partner agreements, which is bad news for the firm and great news for the individual partners. If trouble arises, you can count on the partner causing the trouble using whichever version of the partner agreement leverages his or her situation best, regardless of whether he or she signed it, and the firm will get the raw end of the deal.

However, this point is not to be confused with staff employment agreements. The merged firm should have the staff sign whatever employment agreements the firm uses on the first day of the merger. If you wait, it will cost you serious money (to prove consideration), and it will be significantly more difficult to obtain full compliance. See the book *Securing the Future: Succession Planning Basics* for an example of this document.

Organizational Structure of the Merged Firm

Create an organization chart for all to see showing how all the partners and managers (and everyone to whatever level you normally include in this view) fit within the hierarchy of the merged firm. Without this step, too many assumptions will be made, and those assumptions will almost certainly create damage where it could have been avoided.

When we create organization charts, we use them to show authority within the firm. For example, if one partner is in charge of an office, his or her relative position in the chart will be higher than another partner who works in that office, making it clear who has final authority if staff hear a conflicting message. Although most firms naturally acknowledge this type of positional difference, from the partner level on down the hierarchy, too much “lumping” tends to occur. For example, a manager who the partners see as being over a functional area versus another manager without this authority often is shown on the chart (erroneously, in our opinion) as having the same authority. This kind of sloppiness causes confusion and problems. If the partner group gives more authority to one person with the same title as another, we suggest that this fact be reflected in the organizational chart. This will help both managers in our example understand their positions, and if the lesser manager has his or her feelings hurt because of this knowledge, talk to him or her about what he or she can do to raise his or her personal star within the firm. Don’t wash over this type of information regarding how your operation really works to spare some feelings. Our experience is that this information ultimately comes out anyway, and you can avoid much worse hurt feelings by calling it like it is right now.

Roles and Responsibilities of the Mergee Partners

Obviously, this is really about the roles and responsibilities of all partners. Hopefully, the mergor partners already know this and are indoctrinated with these requirements and held accountable to them. If this is not the case for the mergor firm, then we say don’t merge because you are about to seriously compound your existing problems by making it far more difficult to ever evolve to where you need to be.

Some of the most confused areas of partner roles and responsibilities are the following:

- General expectations (support of firm initiatives, support of other partners, firm internal assignments, committees, projects, teamwork, attitude, loss of temper, relations with staff, and so on)
- Partner personal billings
- Size of book of business to be managed
- Role in developing others
- Required efforts to extend and expand relationships with existing clients and referral sources
- Leverage (how much work the partner does on projects versus delegation to others)

Certainly, more areas for consideration exist, but different expectations in each of these areas tend to cause the most conflict. Make sure you spend time up front clarifying and documenting what is expected, as well as the repercussions of underperformance. Remember, most firms are good at telling people what to do and terrible at providing consequences, with many partners looking at this topic like it is window dressing because it will never actually affect their lives. So, make it clear that it does make a difference to them.

Yes, dealing with problems up front that don't exist might seem like a waste of time, but from our perspective, the more issues you confront at the outset, the more harmonious the merger. Most organizations focus on being nice in the beginning and then cracking down later. We like cracking down from the beginning. If your suitor can stand through this, it will love the firm with which it actually gets to work.

Type of Work to Be Performed by the Mergee Partners

Much of this will come out in the roles and responsibilities previously discussed, but it could be that once the opt out period is over, the merged firm would like to see a partner in the mergee firm take over an office or a department or specialize in a niche and hand off clients to other partners not within that niche.

This also could be a discussion that drives home the point that partners sitting in their offices cranking out billable hours all day will be frowned upon and that their job is primarily client relationship management, not working as a highly technical manager.

It could be something as simple as that partner taking on some critical internal role within the firm, such as oversight over the marketing area, technology, and so on. It could be as important as a person being a potential candidate for managing partner or CEO, and he or she will start the grooming process to see if he or she possesses the necessary skills. The key is to share those thoughts up front.

Ownership Interests of the Mergee Partners

We will talk more about this in chapter 9. Clearly, any deal made will be required to address ownership interests, voting rights, compensation, and retirement benefits.

Voting Rights of the Mergee Partners

This is likely just a review of the merger firm's policies. On what issues do partners vote? How does the governance work? How are decisions made? What powers does the managing partner or CEO have versus an executive committee (if one exists), the board of directors, or an individual partner? Are these voting rights granted immediately or phased in? If phased in, over what period? Do partners vote as a board member (one person, one vote) or do they vote their equity, or both? If both, when is each appropriate?

It is important not to soft-sell this information. It is what it is, and the controls are what they are. Agree to live within this structure, or decide that this is not something to be pursued. Just don't make every process sound like it's a consensus-based act when that is not the reality or vice versa.

Implications of Excessive Owners' Contributions

What happens if a partner of a mergee overperforms and exceeds expectations during the opt out period or any other phase in period? Could the effort affect compensation; equity; or, potentially, both? For example, let's say a \$500,000 firm merged into a \$1.5 million firm, and the beginning split was 20 percent equity for the mergee partner. What if that mergee partner brought in \$1 million of new business during the opt out period? How might that affect the final equity assigned to the mergee partner if the combined firm ended the year with \$3.2 million of revenue?

Termination Process and the Rights of the Mergee Partners

This is critical but ugly to address up front. Obviously, this might not be an issue during the opt out period because this action would simply cause a demerger. However, what if the mergee firm had two partners and one was perceived as too troublesome and would not commit to the merged firm's strategies and processes? How do you separate that person? Additionally, after the opt out period has passed, how do you separate a partner (what vote does it take, notification, and so on), and what rights and privileges does he or she have?

As was previously stated, most of these issues should be clear in your partner agreement or documented operating processes and procedures. If they are not or if they require too large a vote to accomplish, then fix your partner agreement before adding more partners. Every partner you add could be the firm's biggest mistake, someone who can stifle almost all the firm's forward movement and require too many resources to manage (partner meetings, excessive intervention, and so on). So, before you start adding partners, make sure that they are not too difficult to remove. Taking risks to grow and bring in key players to the process is standard business, but locking yourself into mistakes that you will make is just bad business.

Voluntary Withdrawal and the Rights of the Mergee Partners

This is the same as the previous issue, except reversed. In this case, one of the mergee partners wants to leave because the merged firm is not a good fit. Find a way to let these people go, but articulate that up front. Actually, this may be the real reason for the mergee's interest in a merger in the first place—to spin off a few partners with significantly different personal strategies. Under the mergee's existing partnership agreement, the voting threshold to force this action might have been too high.

Voluntary withdrawal should be clearly articulated during the opt out period, as well as after this period. The rights and privileges, or lack thereof, should be clearly communicated to all the partners involved.

Termination Process of the Mergee Clients

This should be a standard operating procedure that you can share with the mergee partners. However, generally, the merged firm will not take action in this area until the opt out period is over.

Minimum Vesting Hurdles for Firm Retirement Benefits

Although the deal may be clear about retirement benefits, when does each partner of the mergee firm meet the vesting requirements? We will cover this more in chapter 9.

How an Upstream Merger or Sale of the Merger Firm Affects the Merge Partners and Any Outstanding Requirements to Fulfill at That Time

What if, during the opt out period or some other phase in period in which the mergee partners are earning full partner privileges, the merged firm decides to do an upstream merger or sell to another larger firm? Does this act then fully vest the mergee partners? Does this act void any earn out or phase in requirements? Is this act even permitted prior to a certain date without sign off from the mergee partners? This is rarely difficult to work out but something to address. You don't want to block the merged firm from taking advantage of future opportunities by allowing one mergee partner to stop the deal. On the other hand, the mergee partners would not want to find themselves as less than full partners if a deal like this quickly occurred.

Initial Salaries or Compensation Versus Falling into the Standard Partner Compensation Plan

Do the mergee partners fall into the merger's normal compensation system from the first day of the merger and the chips will fall where they may, or is there a period when minimum or full salaries are guaranteed? If salaries are guaranteed, can the partner perform at a level to earn more, or is this the fixed salary for that period of time? How is the mergee partner's compensation affected by the managing partner goals? Can a mergee partner's insubordination cause the minimum guarantee to be reduced? These are just examples of questions that might come up when trying to create a fair way to deal with the opt out period and when getting acquainted with the merger firm's processes, accountability, and compensation.

Handling of the Fixed Assets, Work in Process, Receivables, and Payables of the Mergee Firm

These issues need to be addressed in the value calculation (see chapter 9), as well as from a process perspective. Mergers are confusing for everyone—partners, staff, clients, vendors, and so on. So, who gets credit for what, how, and when? Does the mergee firm contribute its fixed assets or have the right to sell them off for whatever they can get? Does the mergee get to bill its existing work in process, collect its receivables, and pay its own payables? Does the merger firm take over the billing, collecting, and salaries starting the day of the merger, or are all of these pooled together to become the property, assets, and liabilities of the merged firm?

This is just common accounting, so it won't surprise anyone. However, cleaning up the accounting messes in mergee firms can be quite a headache because the personal and business income and expenses are so tangled together. This could include loans from the company to the owners, investments, expenses that the merger would not allow as partner perks, and so on. Don't underestimate the mess. On the other side, the merger might be taking the same kind of advantages. So, either side just accepting all payables, receivables, debt, and so on without the due diligence we discussed at the beginning of this section is a mistake.

Handling of the Office Lease or Owned Building of the Mergee Firm

What is going to happen to the mergee's location after the opt out period? Is that office going to be shut down and all the employees moved to the mergor's facilities? If the mergee is going to stay there for a specific length of time, what is that duration, and will the leases be resigned or guaranteed by the mergor? If the office is owned by the mergee, then is this just another disguised perk? If this is not a perk, then what should be the fair market rate? The best time to deal with all of this is up front. The longer a mergee gets to stay where it is and do things the way it has in the past, the more resistance there is to change. Also, having multiple locations might make things a little easier for some clients, but they make it much harder and more costly for the firm because the firm needs to support duplicate functions and infrastructures. Employees of the mergee and mergor firms don't become one firm as fast. Multiple offices make it harder to maximize efficiencies and fully utilize employees. Almost no matter how hard you try, difficult cultures and processes emerge out of different offices.

We are not suggesting that you should default to closing the mergee's office as soon as possible. There could be some significant competitive advantages that arise out of a distributive operation. However, unless you can clearly articulate those advantages and tie extra profits to that decision, consolidating the offices is usually the better approach.

Required Capital Contribution and Timing, if Required

If this is a partnership and the mergee partners need to make significant contributions for their ownership interest, then how long do they have and how much do they need to contribute to bring their accounts into balance? During this period, is any additional advantage given to the partners who already have made the necessary infusion? These are rarely issues that cause conflict within and between accounting firms, but they are part of the standard discussion process.

Mergee Partners' Access to Draws

Mergee partners might be used to taking draws at certain times of the year or whenever they need a personal infusion of cash. Oftentimes, this is around the end of tax season when taxes are due. It also could be based on the lifestyles of the partners as they vacation, want to remodel their house, and so on. When the mergee partners needed money, they might have had a relaxed system and just took what they needed, knowing they were going to earn it anyway, even if this meant dipping more into their working capital line of credit. This situation is especially true for sole proprietors and smaller firms. The point of this issue is to simply clarify under what conditions extra draws are made and what that approval process looks like. As with so many of these points, this should already be articulated in the mergor's standard operating procedures and merely shared with the mergee partners to avoid any unnecessary conflict down the road.

Rights of the Mergee Partners With Respect to Perks, Such as Business Entertainment Expenses, Automobiles, Clubs, and So On

What privileges are given to each partner (what each gets may be different based on his or her roles and responsibilities)? What is an acceptable business expense that requires no other approval in advance? Does each partner have an expense account to use as he or she sees fit? How do partners go about contributing to their personal charities? What is considered a reasonable threshold for such gifts? How does the firm support the community involvement of its partners (for example, does it allow advertising in the local theater, arts festival, and so on in which they are involved)? What about the handling of automobile leases and expenses, country club dues, and other memberships? As you have read so many times before, this should be a documented standard operating process. However, if it is not, formalize it now before you get any further in the merger discussions. You only complicate matters when the merger leaves this kind of process and procedure to be decided after the merger.

Selection of the Managing Partner

Usually, if a smaller firm is merged into a larger firm, this issue is not in question. The managing partner or CEO of the larger firm will continue to be the managing partner or CEO of the resulting entity. However, the following merger situations would provide you with some interesting topics for discussion:

1. A merger of two practices that are close in size to one another (two sole proprietors, for instance)
2. A scenario in which the managing partner of the larger firm is set to retire at some near time in the future

In the first situation, the question of who will lead is a serious issue. It involves not only determining which person will be in charge (you need a single point of responsibility and accountability because if everyone's in charge, no one is really in charge) but also getting a clear understanding of roles and responsibilities and decision-making processes to follow, as discussed throughout this material.

In the second situation, you all need to be clear about when he or she will be stepping down and who is going to be the replacement. We've seen some interesting situations, such as the managing partner being set to retire but deciding on his own not to retire. Therefore, the person brought in via merger to take over wasn't allowed to, thereby trapping him in a firm that he wouldn't have joined had he known this was a possibility. In addition, the managing partner alluded to the fact that his retirement amount was almost agreed to and fair. However, because nothing had actually been agreed to, he decided that a nice way to leverage his retirement proceeds was to stay around and draw a large salary while doing very little.

If you are involved in a situation that may go in this direction, make sure the retirement date is mandatory and that the retirement benefits are set and agreed to so you know this change will occur. Otherwise, you might find yourself in a situation in which you are sold one thing and delivered another. Exercise caution here. The leader of the firm (the managing partner) is a very big decision that affects your future. Deal with this up front and make

sure you are comfortable with the plan. If your instincts tell you that something is wrong, listen to them and force the issue to be agreed to and documented before you take this step. Although demerger is an option, you are far better off avoiding this situation altogether if it is set up to fail.

Rights of the Retired Partners of the Mergee Firm if They Still Want to Work

For many, merger is a doorway to retirement. Mergees often look to the mergor to provide them with a succession plan. A senior mergee partner might be willing to work for the mergor firm as a partner for a couple years in exchange for certain, defined retirement benefits. However, once he or she retires, what rights and privileges does he or she have? Under what circumstances can he or she continue to work for the firm? How will he or she be compensated? What roles might he or she fill? There are many questions here. The key is to articulate them in advance and provide insight into how the process works. It is unfair of a mergor, if it rarely allows a retired partner to actively work, to not state this up front. It also is important to be clear on the conditions required to be met and the approval process for these privileges to be granted. The answers to these kinds of questions can quickly change the deal the mergee is willing to accept. Don't kid yourself; the retiring mergee partner will have this defined before the opt out period is over, so don't waste everyone's time going through a merger that will blow up over this issue. If you do, then expect the firm to end up making a bundle of special provisions (to accommodate this one partner) that are not good business just because you were unwilling to deal with this early. This won't come back just to bite you—it will much more likely have a longer lasting effect and haunt you.

Tax Obligations Not Paid at the Time of the Merger and How Those Will Be Handled Postmerger

Once again, we raise an accounting issue that should be a no-brainer for this group. However, these discussions often don't happen until down the road in the opt out period because they are potentially embarrassing. When you are the mergee or mergor and you are trying to impress the other party in regard to your success, it is rarely a good strategy to throw in "but we owe the IRS a ton because we put off paying them until the last possible time." Just as the cobbler's kids often have terrible shoes, you can count on some CPA firms to have sloppy financial practices—often sloppier than they would ever allow their clients to get away with.

This is not a big deal to address, but if the mergee firm partners pay all their taxes up front and on time and the mergor partners do not, this cash flow issue has to be addressed, as well as the effect it will have on the members of the other firm, whether they be the mergee or mergor.

Vacation, Sick, and Paid Time Off Benefits for the Mergee Partners and Staff

We now come to the last item on our list of issues to address. This one rarely is an issue, but to avoid confusion, it should be stated up front. For example, if partners get six weeks of paid vacation, then how fast does it accrue? Better put, when can a mergee partner take

his or her first day of vacation, sick leave, or paid time off (PTO)? Does he or she get an immediate jump-start, and is he or she granted several days of PTO on the first day?

If you have a sliding scale of PTO benefits based on tenure with the firm, where do the mergee partners fit within that? Are they considered new employees, granted tenure based on their tenure with their current firm, or somewhere in between?

You have to remember that many mergers involve sole proprietors. They have a pretty simple PTO policy. They take as much as they want, any time they want. So, to many, operating with fixed policies such as these is a shock in itself. Therefore, take the burden out by dealing with rules and privileges up front.

Don't forget about staff pay and benefits. Depending on how "rich" one firm's benefits package is compared with the other's, this can be an additional source of potential frustration for you. If the benefits at the mergor firm aren't as robust as those at the mergee firm, you'll have some issues to discuss with the mergee staff, and you could run the risk of some defections as a result.

Keeping the Matter Confidential So That It Doesn't Get Out

Now that you are in the process of fine-tuning the terms of the merger deal, it is time to move to the next step. It is imperative that your plan for a merger not be leaked to anyone during the planning and negotiations. This is especially true in smaller, closer-knit markets where everyone seems to know everyone and rumors fly faster than the wind. As we have said before, this is more dangerous for the mergee than the mergor but not as dangerous for either as a sale. You should still take special care in placing and receiving calls, printing reports and summaries, and saving and delivering electronic versions of them. You can never be too careful. We know of one firm that was entertaining merger negotiations that only the owner group knew about until one of them left a summary in the office copy machine, and a staff person found it the next morning. Needless to say, the possible merger was public knowledge throughout the firm in a matter of hours.

If your staff gets wind of the deal before its time has come, they will assume the worst, and you could find them heading off to work for your competitors or in some other line of business. So, what if they somehow find out before you expected to tell them? Get them into a quick staff meeting and briefly and succinctly tell them what's going on. Tell them why giving you a chance to work out the deal is a good thing for them. Tell them why it will be bad for everyone in the firm if news of the possible merger gets leaked to the clients and others before the deal is completed. Explain your time line. Then, take the time to go through the office and meet with each person individually to re-recruit them and calm any frayed nerves they may have developed. Reassure them that if a merger deal occurs, it should create benefits and opportunities that don't exist now.

Of course, this level of assurance also assumes that everyone you have is a player and a keeper. If you've put off dealing with a problem staff person that you don't think will survive in the merged firm, you need to be very careful to not make any promises that would lead him or her to believe that he or she is in line for something that is not possible.

What about the clients and referral sources? Until you have a deal in the works, you don't want unmanaged communications going out into the marketplace. This results in twisted and inconsistent messages and, sometimes, just plain fabrications. Unorganized communications on either side of the deal also will incite your competitors into action. Premature communications will significantly increase the likelihood of clients becoming nervous and making their own change to another firm before you have the opportunity to sell them on the advantages of the combined firm. So, keep this under wraps until you've got a signed agreement and a ready-to-launch communication plan.

Announce the Change to Your Employees, Clients, and Referral Sources

To help make the transition for both the mergee and mergor firm as seamless and successful as possible when it's time to go public with the news, you need to plan on spending a lot of time communicating with your people, your clients, and your referral sources about the change.

Employees

When the time is right, and assuming you haven't had to perform damage control, you need to let your employees know the who, what, where, when, why, and how of the deal. This is a serious change they will be facing, and they likely will be asking some form of the following questions of themselves; one another; and, hopefully, you. Typically, this is not nearly as big a deal to the mergor staff as it is to the mergee staff because the mergor staff will just continue to do what they have been doing. However, that doesn't mean you should be sloppy with communications to the mergor staff because you might find some of your best employees out on the street looking for work. This occurs for a number of reasons; however, a couple that come to mind are (1) some staff perceive that key mergee staff will replace them and (2) the new combination entity will dramatically change the current operating environment in a way that is uncomfortable to them. By communicating openly about what is occurring on both sides, you will be able to quickly alleviate many of the concerns.

Because this conversation is more sensitive on the mergee side, we have included some dialogue for you to review. Obviously, these are just examples of questions we have heard, but because you know your people better than anyone, you need to think through the kinds of questions they are likely to ask so that you have a well thought out, calming answer. Here are some common questions and responses:

Q: Why is this happening?

A: I've come to a point in my life where I started thinking about retiring so that I can spend more time pursuing (your list goes here). I needed to develop a succession plan that would provide you with a similar place to work, as well as a way to see that you could continue to serve the clients you have come to know over the years. I felt both you and our clients deserved this level of consideration. I don't plan on leaving for a while, but I believe this is an important planning step for everyone's future.

I've looked at several firms, and XYZ Company seems like a really good fit for us and our clients. They have developed outstanding support infrastructure and training that we could put to use right away to help take the pressure off our workload.

Q: Is something wrong here or with us or me?

A: Absolutely nothing is wrong with any of us here [unless this is not true]. I just need to merge with a firm that will provide us all with the support we need to keep growing, maintain our profitability, and allow me to ride off into the sunset at some point in the future knowing that everyone still has a home.

Q: What does it mean to me? Will I still have a job?

A: As part of the deal, everyone here will have a job at the merged firm (you need to have already talked to those you will be letting go, and quite frankly, you should have let go of poor performers long before this). However, just like me, although we will all be given a chance, it is not guaranteed that we will still be with this firm six months from now (just as it is not guaranteed now). Based on the fact that you have done good work for me, you know the clients, and they like working with you, this should be an easy transition.

Q: Even if I do stay on, who are these guys, and how do I know I want to work for them?

A: Part of my screening of potential candidates involved looking at how they run their business, how they're staffed, and so on, and I believe that anyone who wants to work for the merger firm will be happy with them. However, we will be setting up a time for you to meet with some key people at the merger firm and that will be a great time to ask any questions you have. The bottom line is that I am going to work for them, too, and I would not do this if I didn't believe in what they are doing. I think you will be excited.

Q: What will you expect from me between now and the final merger?

A: I expect you to keep this quiet until we make the formal announcement to the clients and referral sources. They need to get one, consistent message about this, and we'd like to have all of you direct their questions, comments, and concerns to me. If someone probes you about what is going on, all you have to tell him or her is, "I appreciate your concern, and it's something that the owner is looking forward to talking about with you. I'll see that he calls you or drops by."

I'd also like to ask you to keep an open mind. I hope we have put together a win-win situation for everyone.

Q: What about my sick leave, vacation accrual, comp time, and other pay issues?

A: [Your answer here needs to address the differences and similarities in a general sense, with an honest disclosure of what likely will be different, what the firm will do about transitioning any differences, and so on.]

Q: What can I expect from you?

A: I will be talking with each of you individually about your concerns and desires and will be available to provide you with whatever moral support I can. This isn't the end; it's the beginning of a new chapter in your career.

Other issues will likely surface, but the preceding questions and answers should give you an idea regarding a place to start. Remember, people don't necessarily resist change; they resist the ambiguity in their life that a change will cause. For some period of time, they'll be feeling as though they've lost control of their professional life, and they will be worried about what's just around the corner for them, especially if they've become really comfortable working for just you. Your job is to eliminate the information vacuum as much as you can through constant discussion and feedback and by letting them know what you can, when you can. When an information vacuum exists, it usually sucks in enormous amounts of misinformation that will take a toll on your firm and all the people involved, including you.

Clients

It's really important to get your clients on the same page regarding the mergee and mergor firms as soon as you can. Because this is not a sale of a practice, client turnover should be minimal. One exception is clients who may have come to you in the past after becoming dissatisfied as clients of the other firm. Conflicts also may arise, but you should have identified those in advance of finalizing the deal.

We recommend a couple of different passes at communicating your transition with your clients. For key clients and long-term clients who aren't necessarily the largest in the book of business, we recommend a personal call or e-mail to them to tell them the following:

- What you're doing—you're not leaving; you're just changing the firm name, so to speak
- Why you're excited about this combination of firms
- You searched far and wide to get a good fit in a mergor firm for them
- You're looking forward to continuing to serve them through the merged firm

We suggest you also consider following up with a letter to each of them. The letter can restate what you covered in the call or e-mail, and it can provide even more information to help them become more comfortable with the change. We've included copies of the letters in appendixes A, "Client Letter From the Mergor," and B, "Client Letter From the Mergee," of this chapter.

The two firms also will want to do press releases to announce the new marriage to the public. We've included an example of a press release in appendix C, "Sample Press Release," of this chapter.

As is the case with staff, you can't overcommunicate with your clients on this matter. If clients call and ask your people what's going on, the clients need a consistent message. Make sure you have a script made up for all your staff, from the receptionist to the manager, that says something to the effect of, "Yes, we're merging with XYZ Company, and we are excited about it. We appreciate your concern, and it's something that Joe is looking forward to talking about with you. I'll see that he calls you to talk to you about this." Keep the messages consistent and coherent, and leave as little to chance as possible.

Actively Participate in the Merger Integration Between the Two Practices

In order to really make the merger work, both firms will need to make sure that the new practice, people, and clients are appropriately integrated into the new firm. In rare circumstances, this could involve task forces from both firms working on topical areas to choose best practices that the newly merged combination of firms will use. For example, these areas might deal with business development and client acquisition and retention, firm accounting, timekeeping and billing, human resource practices and policies, operations, file maintenance, and quality control procedures.

If, as a result of the merger, the business or governance model or processes needs to change, owners from both sides of the merger might work out a new, common approach. However, we suggest that you curtail this possibility from the start because it usually spells disaster. We like the language clearly stated in the agreement to say something like this:

Although the mergor is always open to hearing new ways to conduct business and best practices ideas from the mergee, the merged firms will operate following the mergor's agreements, processes, policies, and so on until otherwise directed by the mergor.

We know that is not the exact language you should use, but the intent should be clear. Mergers are much more successful when they are not entered into with the idea of taking the best from each firm. Why? Because each firm believes almost all of what it currently does is the best practice or is superior to the other alternatives. Therefore, it is critical that it is clearly understood that the mergee firm and its people are expected to conform to the practices of the mergor firm. Integration in this type of situation involves training, orientation, and follow through to indoctrinate everyone in the mergee firm on the policies, procedures, and practices.

At the end of the day, this is a foundation point for all CPA firms. Although each partner might have conceptualized a fantastic way to operate the firm, just as each firm in a merger might feel as though it has authored the best practice approach in an area, you cannot have two, three, or four simultaneous approaches in play and be efficient or effective. Everyone has to follow one set of rules. It doesn't matter that each partner or each firm could be very successful following their approach on their own. In order to be successful, everyone has to submit to the same approach or empires and factions start evolving. So, although many great ways to run a practice exist, you need to decide on the approach everyone is going to follow. We believe that whatever the mergor does usually should be the default until otherwise notified.

The Bottom Line About Merging

As you can see, a variety of arguments exist for and against considering mergers in the context of succession management. If you do decide to pursue an upstream merger for your practice, make sure that you aren't hooking your wagon to a firm that's less well managed than yours or has more serious governance problems than yours. On the other hand, if you are pursuing a downstream merger, make sure that you understand what you are taking on and that your infrastructure can handle the load you are about to place on it. If you are not careful, the mergee or mergor can end up in a far worse situation after the merger than it was before taking this step. Take your time to clarify exactly what you plan to get from the merger, as well as understand what you will have to give up to get it.

Appendix A

Client Letter From the Mergor

(Date)

Dear (Client):

We are writing this to share some important news with you. Our firm (XYZ CPAs LLC) is merging with the San Antonio firm of ABC CPAs LLC. We chose to merge this firm into ours because of the special talent and services they offer that would be valuable to many of our clients.

We very carefully selected ABC CPAs LLC as the right choice for merger because they are a highly regarded firm with a wonderful reputation for taking great care of their clients. Through this merger, we will not only be able to continue to provide the quality of services you have come to expect, but we also can expand our offerings to include some of the many services you have requested over the years. In addition, by building on the strengths of both firms as CPAs, business advisors, and management consultants, we will be able to continue our ability to attract the most talented professionals in the industry.

Due to their management consulting expertise and industry specialization in construction, manufacturing, and professional practices, they bring a wealth of new offerings to our menu. The new firm will be known as XYZ Group, LLC. The merger becomes effective on January 1, 2010. Please take a moment and look at our new Web site to read about some of the superb talent available to you (www.xyzgroup.com).

We look forward to talking with you about this soon. In the meantime, please don't hesitate to contact me if there is anything we can do for you, if you have questions about the merger, or if you would like some additional information.

Sincerely,

XYZ CPAs LLC Managing Member

Appendix B

Client Letter From the Mergee

(Date)

Dear (Client):

I am writing this to share some important news with you. My firm (ABC CPAs LLC) is merging with the Austin firm of XYZ CPAs LLC. This is an exciting and strategic move for us!

I very carefully selected XYZ CPAs LLC as the right choice for our merger because they are a highly regarded firm with a wonderful reputation for taking great care of their clients. Through this merger, we will not only be able to continue to provide the quality of services you have come to expect, but we can expand our offerings to include some of the many services you have requested over the years. In addition, by building on the strengths of both firms as CPAs, business advisors, and management consultants, we will be able to continue our ability to attract the most talented professionals in the industry.

XYZ CPAs LLC is recognized as Austin's top accounting firm for its management consulting expertise, as well as audit, accounting, and tax services. The firm also has extensive experience serving clients in construction, manufacturing, wholesale, retail, nonprofit, and service industries, such as professional practices.

The new firm will be known as XYZ Group, LLC. The merger becomes effective on January 1, 2010. Please take a moment and look at our new Web site to read about some of the superb talent available to you (www.xyzgroup.com).

I look forward to talking with you about this soon. In the meantime, please don't hesitate to contact me if there is anything we can do for you, if you have questions about the merger, or if you would like some additional information.

Sincerely,

ABC CPAs LLC Partner

Appendix C

Sample Press Release

For Release: December 15, 2009

Contacts:

Joe Doaks: 512-555-0000, joed@www.xyzgroup.com

Jane Doe: 213-555-1111, janed@www.xyzgroup.com

San Antonio Firm Merges With Austin Accounting Firm

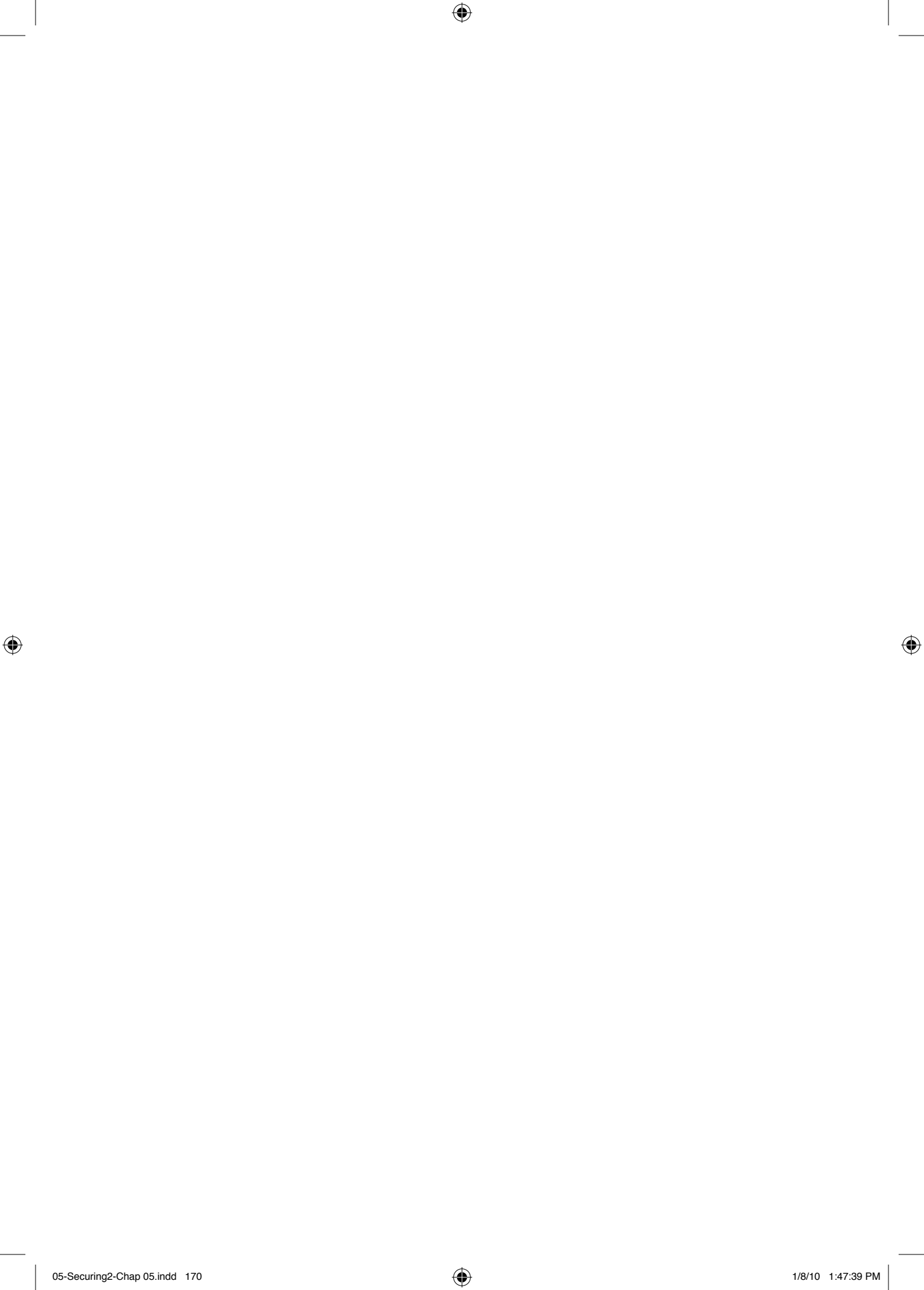
San Antonio, Texas (December 15, 2009): The San Antonio accounting firm, ABC CPAs LLC today announced its upcoming merger with XYZ CPAs LLC, an Austin-based accounting firm. Effective January 1, 2010, the new firm will be known as XYZ Group, LLC (www.xyzgroup.com).

"This strategic merger provides us with tremendous opportunities to broaden our professional services and geographic reach," said Joe Doaks, managing partner of ABC CPAs LLC, adding, "We are excited about being associated with a firm that has the stature and reputation of XYZ."

"This merger will bring benefits to the clients and employees of both firms," said Jane Doe, managing member of XYZ Group, LLC. "Our clients will have access to increased levels of service and expertise, and our firms will have additional opportunities for growth and expansion. By building on both firms' strengths and reputations as CPAs, business advisors, and management consultants, we will be able to continue to attract the most talented professionals in the industry."

Established in 1963, ABC CPAs LLC is recognized for its management consulting expertise, as well as its industry specializations in construction, manufacturing, and professional service firms. Mr. Doaks is nationally recognized for his consulting work in strategy, organizational infrastructure, performance measurement, and organizational development.

Founded in 1969, XYZ CPAs LLC has been providing professional services to large and small businesses throughout the central Texas area for nearly 50 years. The firm was recently recognized as the top accounting firm in Austin and is highly regarded for its business auditing, accounting, tax, and management advisory services, as well as individual tax planning and preparation. "The combination of talents between our two firms will bring a wealth of new offerings to our service menu—offerings that many of our clients have been asking for," said Jane Doe.



Chapter 6



Sole Proprietor Who Wants to Work Until He or She Turns Off the Lights and Walks Away

Introduction

Some CPAs like to work and don't want to retire. To them, a life that would have them stop working in their mid-60s, stay home, and enjoy their various hobbies is incomprehensible. So, they implement a business model that lets them work a little less each year and that allows them to continue working with clients while reducing stress and work complexity.

Their plan is to work as long as they want to work, and when they no longer enjoy what they are doing, they will just get up and turn out the lights of their business once and for all on their way out the door.

In this chapter, we'll provide you with some food for thought if the Turn Out the Lights Strategy is one that is of interest to you. Generally, this can be a reasonable strategy. Properly planned, it also can be economically rewarding. However, you have to overcome several obstacles to make this strategy work for you, with key obstacles outside of your control.

The single biggest issue is health. Although you may be healthy today, we all know this can change overnight. As long as you want to work and you can stay healthy, this is likely the most economically rewarding approach of all. Consider a firm with annual revenue of

approximately \$300,000. Using a very simple set of facts with no complications, a good sellers' market, and full client retention by the buyer, which would be rare, you would likely receive approximately \$75,000 per year for 4 years.

However, let's assume you want to work; you could create a model of reducing your revenue by approximately \$25,000 per year for the next 12 years. So, in the first year, you would bill approximately \$275,000, the next year approximately \$250,000, and so on until you were at zero. This model would allow you to work a little less by firing a few more clients each year. At the end of 10 years, you would be billing \$50,000 per year and less than 1 day per week's worth of time. However, during this same period, you would have billed approximately \$1.625 million. If you assume that 60 percent of that money goes directly in your pocket, which is a very conservative number, you would have earned \$975,000. In all likelihood, you will be able to get something for the \$50,000 worth of clients you still have.

As you can see from our example, the Turn out the Lights strategy will end up paying you well over three times what you would have received for selling your practice. However, to come back to the key issue mentioned earlier, this assumes you stay healthy the entire time and enjoy the work. This strategy is like gambling—it has high risk and potentially high rewards.

It also has the added requirement that you have to work the entire time—albeit less and less each year. So, if you would rather be playing ... then you probably won't make this work for you. But if you are like many people we work with, you may be happiest coming into the office and doing a little work each day. So, for those who are interested, we've developed this section outlining some tips to help you maximize your return if you decide to invest in this strategy.

If you, like many others, plan to keep working until the day you simply don't want to come in anymore, you probably will provide one or more of the following answers when asked why you don't want to sell or merge:

- I like what I'm doing and I can't ever see not doing it at some level. Besides, if I expect to find myself short of cash for various activities I want to enjoy, then why go out and take a part-time job as a greeter at Walmart when I can make far more money far more easily by just keeping my practice (partially) open? This way, I can maintain an easy-to-manage, small client base doing the things I like to do and the things I know how to do and provide services that my clients appreciate.
- I don't have other, significant recreational interests to pursue, so why stop working? It's as good a use of my time as anything else.
- I can't afford to totally quit, due to a small or nonexistent retirement nest egg outside the practice (for example, Social Security payments will not buy many airline tickets, antique autos, and so on).
- I enjoy doing my thing without the hassles of staffing, so I will just work as long as I can on my own. When I decide to close the doors, if someone wants to buy what is left, I will be glad to sell it. However, as long as I am physically and mentally able, I would rather do the work than find myself at home watching my days pass.

- I don't have an interest in growing the business any further or spending a lot to upgrade technology any more than is absolutely necessary; I just plan on slowing down in conjunction with my business.
- I am at a stage in my career where many of my clients are my contemporaries, and as they sell out or retire, I will just cut back somewhat on my hours, which suits me just fine.

What's wrong with these answers? Nothing. All of them represent valid reasons for someone to opt out of the mainstream and do their own thing in their own way until they choose to or have to retire. Even taking this approach does not preclude the sale of some residual practice value when the proprietor decides to hang up his or her shingle.

One more message is rarely spoken, but it is at the heart of this issue. For many of us, as we near retirement, more and more people we know pass away. The most pervasive perspective we hear sounds something like this: "Bill was so active and full of life, but it seemed as though right after he retired, he started deteriorating fast. I am a little scared that the day I quit working is the beginning of the end for me. I am going to keep going to work as long as I can, at least at some level, because I think that focus will keep me in better physical and mental shape for a longer period of time."

Some simple demographic issues also need to be considered. When the Social Security system was created, the year you turned 65 was the year you were entitled to full benefits, partially because the average age of death was approximately 67. This system was meant to be a bridge to allow people in the last few years of their life to have some financial support. Today the estimated life expectancy in the United States is 78.¹ It is not uncommon for people to retire at the age of 65 and then live another 30 or more years after retirement—literally, another one-third of their life. So, if the original plan was to provide support for maybe a few to several years but for many, their life expectancy will be approximately 30 additional years, doesn't it make sense that people will be trying to stretch out their work lives, too?

As you can see from the preceding comments, this is true for far more than just financial reasons. We are fortunate that much of the work many CPAs do can be performed when people are in their 70s and even their 80s. Although people choosing this path often remove themselves from the more complex work, such as audits and reviews, plenty of value can be provided to clients in the tax, planning, and advisory areas. Having been around the block a few times (and for many of us, a few times more than we would like to admit) gives us a lot to offer. So, we are finding that many sole proprietors and even partners in larger firms spinning off on their own late in their careers are pursuing a work-life-leisure life balance that is unique and well supported by the Turn Out the Lights business strategy.

¹ CIA's *World Factbook*, 2009. Accessed 12/09 at www.cia.gov/library/publications/the-world-factbook/index.html

Potential Financial Benefits of the Turn Out the Lights Strategy

This approach has some potential benefits. You could easily net much more from your practice through this approach than by selling it. Consider the following example:

Annual revenue of the practice	\$400,000
Years you might want to continue to work at a slower pace before you walk away	8

If you were to sell this practice at a price of \$1 per dollar of revenue, you would theoretically get approximately \$400,000 over some agreed-upon period of time. Now, a lot of reasons exist why you wouldn't get \$400,000, which we will cover in chapter 9; however, for the sake of this example, we are keeping this simple.

Let's take a look at what you might realize if you continue to operate the practice for the next eight years while gradually reducing your amount of work, which will correspondingly reduce the amount you earn each year. The workload reduction we are assuming, based on conversations with many people pursuing this option, would come from a combination of the following:

- Normal client attrition (sales of businesses, deaths, relocations, and so on)
- Clients leaving because they can't allow all their institutional knowledge to rest in an individual who could retire at any time or, worse, be incapacitated due to the probability of age-related health issues
- Change in scope of services offered in order to reduce the complexity or regulatory compliance required to perform the work

Assuming that you reduce your workload by approximately one day per week each year, you'd reduce your revenue by approximately \$50,000 per year. If you assume that you keep approximately 60 percent of your revenue as net income, you'd net more than \$800,000 from this practice.

If you were to assume a longer phaseout period, you could then assume that you would net even more from this approach. As was previously noted, some CPAs are able to work into their 80s, so a lot of money is on the table under this option, along with other perceived intangible benefits (for example, the belief that continuing to work at some level will keep you physically and mentally stronger longer). This type of scenario can result in earning from two to three times what you might otherwise obtain from a sale.

Annual Revenues Each Year, With a \$50,000 Reduction in Fees per Year	
Year 1	\$ 350,000
Year 2	\$ 300,000
Year 3	\$ 250,000
Year 4	\$ 200,000
Year 5	\$ 150,000
Year 6	\$ 100,000
Year 7	\$ 50,000
Year 8	\$ 0
Total Revenues Received	\$1,400,000
Assumed 60% Net to Owner	\$ 840,000

For this strategy to make any sense to pursue, three key assumptions are at work:

- The first is that you like what you're doing or that you want to continue to work, or both
- The second is that you can stay healthy long enough to put in enough time for this strategy to pay off
- The third is that you have to actually do the time to make your money versus just leaving and collecting your money

The first issue is easy enough to manage. As soon as you decide you don't like the work anymore, you can either turn off the lights and walk away or sell off what you have. The distinction between these two choices is that during this time, because you were modeling the Turn Out the Lights strategy, you were not running your firm in a way that would make it more valuable to the marketplace but, rather, in a way that would make it more valuable to you as a dwindling asset you could manage. Therefore, you have to understand that what you have to sell might not be as valuable as what you might have built if your focus had been different.

The second issue is the one that bites everyone—health. You may be healthy today and you may have a family lineage that is as durable as a tortoise, but your health is something that can, and often does, change overnight. This second issue is the “make or break” factor in this strategy.

The third issue is about what you want to do with your life. If you sell out, you can go play golf every day, write that book you have always wanted to write, or take those long vacations you have talked about for years. If you stay the course, then you have to balance some of those outside interests with the requirement of continuing to take care of your clients, although doing so over a declining number of hours.

If you pace yourself, manage your work, and stay healthy, this is likely the most beneficial and enjoyable strategy for numerous reasons. Many CPAs we talk to embrace this strategy because it provides more money for retirement-type activities, such as hobbies, travel, and so on, and it keeps alive the lifelong experience of being part of a vital and challenging profession.

Should your health fail too early in the implementation of this strategy, you or your estate may only end up with the fire-sale value for your business because your firm was not being maintained to maximize market value and you were managing it as a dwindling asset.

Getting From Here to There—Solo Practitioner

For the sole practitioner who is a lone wolf (this includes the spin-off partners from larger practices who set up this practice upon retirement) with no employees, a few major, strategic issues need to be considered for optimizing success:

- Acting as the general contractor for your clients
- Staying current with technology

- Staying current with charge rates and fees
- Disability coverage
- Practice continuation agreement

Acting as the General Contractor for Your Clients

If you want to keep your existing client base around for the foreseeable future, you'll need to be sure that you are identifying and meeting their ongoing needs for professional services. The business environment, and public accounting in particular, is far too complex for one person to be all things to all people, but your clients expect more than just timely, correct tax returns and financial statements. They want help solving their business problems. The good news is that they don't actually expect you to have all the answers or know everything there is to know. They simply want you to recognize that they have other concerns besides tax compliance and financial reporting, and they want you to help them get the assistance they need.

That's where the general contractor model comes in. You can build client loyalty by handling this properly, and you can actually earn fees while you're doing it. Rather than ignoring clients' needs outside your area of expertise, you identify the needs and then find other professionals who could help your clients resolve those needs. We are not talking about merely giving your client another specialist's name; we are suggesting that you actually stay involved at a high level while the work is being performed, much like a general contractor does with his or her subcontractors on a construction project. You would get paid by the client to act as his or her advocate, provide insight, and keep things moving along.

Building this network allows you to do a better job of keeping your clients much longer because more people are involved who have knowledge of your clients' situations and histories. This approach takes away the fear a good client will have that staying with you might leave him or her stranded should something happen to you. It allows him or her to justify staying with you longer because your network of specialists provides him or her backup support. Without this more formal network of resources, you will force some of your best clients to go elsewhere, not because they want to but because they have a duty to the companies they run to protect their organizations.

Another benefit of this approach is that it takes pressure off you to stay currently educated on a broad spectrum of topics. Using this approach, you can continue providing the services you are most comfortable performing and provide additional services with the talents from other CPA firms. All you have to do is create an agreement that outlines that when a network firm takes away one of your clients, it agrees to pay you for the privilege (for example, two times annual revenues). This will keep everyone working together. If by chance a client decides to transition to one of your network firms, then at least you will be paid well for the privilege. Although you can't stop a client from deciding that he or she needs to be serviced somewhere else, this approach can help build a financial bridge that works in your favor.

Another benefit of this approach is that it leverages your vast experience. Rather than trying to position yourself as the walking tax library or financial statement guru (complexity is making that harder and harder to pull off), you are positioning yourself as someone who knows a great deal, has seen a lot, and is perfectly suited to provide advice or act as a sounding board for various ideas.

Finally, because your clients are used to working with your professional network, when the day comes that you decide, for whatever reason, that it is time to take down your shingle, you have a built-in set of firms that are excellent candidates to pay you to transition your clients to them.

The general contractor approach to running a firm implementing the turn out the lights strategy provides enormous short and long-term value to your clients and you, financially and in terms of providing you peace of mind, less pressure, and a backup strategy in case of a health crisis. To find out more about the general contractor approach, take a look at the Private Companies Practice Section Trusted Business Advisor Resource Center. You will be able to review a variety of workshops and other tools that can assist you in developing this area of your practice.

Staying Current With Technology

One key to continuing to run a profitable professional practice is to stay abreast of technology as much as possible. For one thing, it helps create efficiencies that can prop up your bottom line. For another, it helps minimize the need for more people and the resulting increase in overhead and entrepreneurial hassles for someone who's not really enthusiastic about hiring and developing people. Yet, technology has its cost to the CPA, and it's an investment that must continually be built into plans and budgets. This is true regardless of your retirement plans.

The key issue here is investing in technology for the sake of leveraging the sole proprietor's time. Although it is easy to hire someone part-time to help provide services to clients, too often, no one else is around but you. So, although we are not suggesting that you try to stay on the cutting edge of technology by any stretch of the imagination, we are suggesting that you stay current. We have found this is best done by hiring an outside professional technology person who is under contract to

- upgrade your computer systems and phones regularly enough to ensure you are fairly up-to-date.
- keep your system secure.
- maintain backups of your data to protect your critical files.
- upgrade your professional software when necessary.
- help you maintain your files in a paperless environment.

For many of you who are reading this, you might be saying to yourself, "Do these guys know that I didn't grow up around technology, so this suggestion is way off-base?" We understand your perspective, but think of it this way. When you utilize a network of other professionals, staying current on technology will help when you need to exchange information. For example, sending documents and spreadsheets between firms when the versions of the software are vastly different creates a number of needless problems.

Having reasonably current technology provides a level of confidence in your clients, too. When a client walks into your place of work, whether that is in an office or your home office, he or she expects you to meet a certain minimum standard of technology. When the client sees nothing but equipment he or she replaced five years ago, it is logical that he or she might also start to wonder if it is time to update his or her accountant. Staying abreast of technology also makes whatever work you might sell in the future more valuable because everything is digital and easier to transition to the next firm.

Finally, our experience tells us, based on the times in our lives when we have worked as sole proprietors, “Don’t be stingy with your technology dollars.” Look for ways for technology to leverage your time and make you more productive. Remember, when you work alone, technology is a support system that shows up every day and works as tirelessly as you. At the end of the day, the Turn out the Lights strategy is about leveraging whatever time you want to extend to your business and making the most of it.

Staying Current With Charge Rates and Fees

A foundation principle of the Turn out the Lights strategy is fee management. You need to constantly raise your rates for a number of reasons. The first one is that you need to teach your clients to pay market rates for the services you provide. When you start giving your services away, you are telling your clients that you are not worth much.

Second, as you lose some of your clients each year, which is a planned part of this strategy, you can make up for most of this attrition with annual fee increases. This way, each year, you set yourself up to work a little less and make approximately the same amount or maybe even more.

Third, by maintaining closer to market rates, you are protecting the value of your business should it have to be sold in short order by you or your heirs. For example, upon the activation of a practice continuation agreement or the takeover of your practice by a new firm, your firm will generate far less value if the clients have not been paying approximately market rates. The sticker shock your clients will face when billed by the successor firm could easily be enough to make them run to other alternatives. This will decrease the amount of money you or your heirs will receive from the sale of the practice.

Fourth, as with all of our strategies, you want to keep your good clients and run off your bad ones. Your bad or marginal clients aren’t really worth anything to you now or in the future (no one else wants them). So, whatever time you want to spend working, make sure it is to serve the clients who really want your help, not those who constantly complain and want you to give away your time. Too often, as CPAs move into this strategy, they end up growing the amount of free work they do and inadvertently run off the good paying clients because they are too busy to be available to them. Because planned client attrition can be both complex and emotional, we have included a client evaluation spreadsheet in chapter 3 as appendix B, “Sample Client Evaluation,” to help you rate your clients and work through this process.

Fifth, as you move more into the consulting or advisory role and away from the heaviest technical roles, realize that your price should go up. You should only charge so much per hour for depreciation schedule maintenance. Why? Because this work takes far less

experience to perform. However, when you consider that you have worked with hundreds or, for many of you, thousands of businesses over the years, think of the knowledge of best practices you have locked up in your head. As you spend more of your time trying to understand the needs of your clients and utilize your vast network of professionals to help them, you will find that your involvement is more sought-after and of higher value.

So, it is time for you to cash in a little for performing accounting work and working alongside your business clients. Don't give your time away just because you are slowing down. Rather, you are becoming a scarcer resource, and we all know that scarcity drives up price; it doesn't reduce it. One more advantage is that although youth is no longer on your side, the advisory area of practice is also one that younger people have a harder time pulling off because of their lack of experience and network. Leveraging your strengths and minimizing your weaknesses has always been a good business strategy. It's time to take advantage of all you have to offer and make more money for less work, rather than slipping into the abyss of giving away the time of your life. Charging and receiving a premium for experience and expertise may expand even further the satisfaction of continuing to practice. As an aside, in our inflationary times, clients are surprised when our fees for service do not increase regularly.

Disability Coverage

Because you are the production generator in your business, you should be sure that you have adequate income replacement or disability coverage in place. The AICPA has a great program. Don't be penny wise and pound foolish. Although no one ever expects health issues to stop them in their tracks, this occurrence is all too common in our profession. One day, you are the epitome of health, and the next week, news of a life threatening disease or ailment is unveiled. Don't let your health ruin you financially; invest in some insurance coverage to mitigate your risks.

Practice Continuation Agreement

In a recent AICPA survey,² sole practitioners indicated that, for the most part, they don't have practice continuation agreements in place. This means that, should they become partially or totally disabled or die unexpectedly, the residual value locked up in their books of business will simply go away. In turn, this could leave them and their families in potential financial turmoil. This is something that can be avoided. All it takes is the execution of a practice continuation agreement between the solo practitioner and one or more compatible firms. For the inside scoop on practice continuation agreements, see *Practice Continuation Agreements: A Practice Survival Kit* written by John A. Eads, CPA, and published by the AICPA. This book explains how you can preserve the value of your practice and features a sample action plan, a sample practice continuation agreement, and sample correspondence.

If you are looking for a less legal and more simplified solution, consider the general contractor approach we discussed earlier. If you spend time now building a network of firms with which you work closely, then as you introduce other firms to your clients, write up a

² AICPA. 2008 PCPS Succession Survey. The Succession Institute, 2008.

simple letter agreement that outlines the price to be paid if one of those firms takes one of your clients from you, as well as the price you will accept if you decide to transition certain clients to them. The reality is that every firm that assists you with one of your clients is an easy target to which to sell those clients when or if the time arises.

Getting From Here to There—Sole Proprietor With Professional Staff

For the practitioners with professional staff, a variety of issues need to be addressed under the just walk away option of dealing with succession and retirement:

- Acting as the general contractor for your clients
- Staying current with technology
- Staying current with charge rates and fees
- Disability coverage
- Practice continuation agreement
- Staffing and facility requirements

The first five issues have been covered under the previous discussion for solo practitioners and also apply to sole proprietors with professional staff. The one we did not cover previously we will cover now.

Staffing and Facility Requirements

One of the issues that a nonsolo operator faces is what to do with his or her staff as the practice gradually winds down over time. In many cases, the professional staff will find other opportunities for employment long before the owner chooses to turn off the lights and walk away. When your staff either learn about your exit strategy or see it in place in the form of a no-growth approach to the business, most of them will likely look for other, long-term employment. Thus, the gradual reduction in the practice size may not occur exactly as the owner is hoping.

Although looking for long-term employment is certainly true of your full-time staff, it is less true of your part-time staff. So, by being creative and having an open dialogue about your plan, you might be able to strike a good deal for you and them to hang around and continue to serve your clients. Who knows, they might even be interested in taking over your dwindled practice because it is being reduced to a part-time effort.

Additionally, the owner may be faced with facility costs that were designed around the initial size of the practice but later reflect excess building capacity for the practice. This, of course, can be handled through a move to a smaller space, assuming lease terms allow for it. If the practitioner owns the building, he or she might be able to lease out space. In any event, it is another one of those factors that must be taken into account. At some point, nothing is wrong with moving into a home office. Working at home has become ubiquitous, with more and more of our work being transmitted electronically or handled via phone. So although someone who has worked in an office all of his or her life might see

moving to a home office as a major roadblock, your clients won't. They will be happy with a "This move will allow me to continue to serve you at the same rates this year" type of letter, and you will end up making more money because of it.

Conclusion

The Turn Out the Lights strategy is a very lucrative approach. This is especially true of someone who enjoys the work and the pleasures of serving favorite clients, plans to work past traditional retirement age, is going to work doing something anyway, and wants to slow down and make time for more leisurely pursuits but desires the ability to increase personal income almost on demand to pay for the leisure lifestyle he or she envisions. Think of it this way: under this strategy, many CPAs are able to schedule their workload around their travels but take on the work based on the extravagance and frequency of those planned excursions.

However, health is the major wild card when selecting this path. You can mitigate that risk by (1) buying disability insurance; (2) creating a practice continuation agreement with a friendly firm; and (3) embracing the general contractor approach, creating a robust network of firms that work with you and your clients, and generating letter agreements that will benefit all involved.

As for the profitability of this approach, as we discussed earlier, it can be far more lucrative. Don't get lazy with your pricing, don't get stingy with your technology investment, and don't get sloppy about making time to take care of your good clients.



Chapter 7



We Need to Develop New Leaders for a Successful Transition

Introduction

When many CPA firm owners engage us to help them prepare for coming succession management approximately five years in the future, their focus is almost entirely on buying out the senior partners, transitioning clients, and developing policies to address the soon-to-be retirees. Common questions include, “Should we have a mandatory sale of ownership age? What kind of payment terms are reasonable? What about noncompete agreements? What is a fair valuation of the firm for retirement payouts?” Our initial response to these questions is, “It doesn’t matter.”

It doesn’t matter, at least initially, for most firms that are in the beginning stages of succession management. In our opinion, focusing on these issues at the outset of succession planning is putting the cart before the horse. Although these clearly are important matters to consider, for many firms, owners must first successfully address a host of other, more pressing issues.

Our focus in this chapter is on those more pressing issues because we have reserved the other issues that are focused on retirees in chapter 8. You’ll learn why most entrepreneurial CPAs need to invest in a robust governance structure at their firms before they can plan a smooth exit. You’ll also learn about the need to help your partners develop and grow in

their management and decision-making skills, as well as how to formalize that process to assure that your firm continues successfully after you leave.

We want to make a couple of comments here about governance structure because it's one of the most confusing and politically sensitive areas to change. A proper governance structure allows for the right blend of discussion about organizational strategies, budgets, policies, and procedures at the board level. It requires that roles and responsibilities be assigned to the managing partner or CEO, the board of directors, and the line partners. Proper governance creates a system to hold partners accountable. It also allows owners to either rehabilitate or counsel out dead weight partners or owners.

Proper structure, policies, and procedures also help firms develop their junior partners. If you want your partners to be able to take over when you leave, you need to invest in small losses now and let them learn how to lead while you are still around to help them avoid big mistakes. In other words, let them make mistakes commensurate with their positions. This is the same issue we have seen in family businesses for years. The kids of the owners are ill prepared to take over because as long as dad and mom were around, all the decisions fell to them. So, the kids never built a gut—those instincts that alert us about whether we are heading down the right or wrong path.

The key here is to let your young leaders do some things their way. Some of their ideas will fail. If they do, you're not only helping them build their gut, but you are in a position to contain the damage. Also, don't be surprised when some of your young leaders' harebrained ideas work because it might be that you're the one who's out of step, not them.

To make this personal growth experience good for everyone, you need processes that force these younger partners to formalize their exciting new ideas into a business plan model that challenges them to think through everything within a planned time frame and budget.

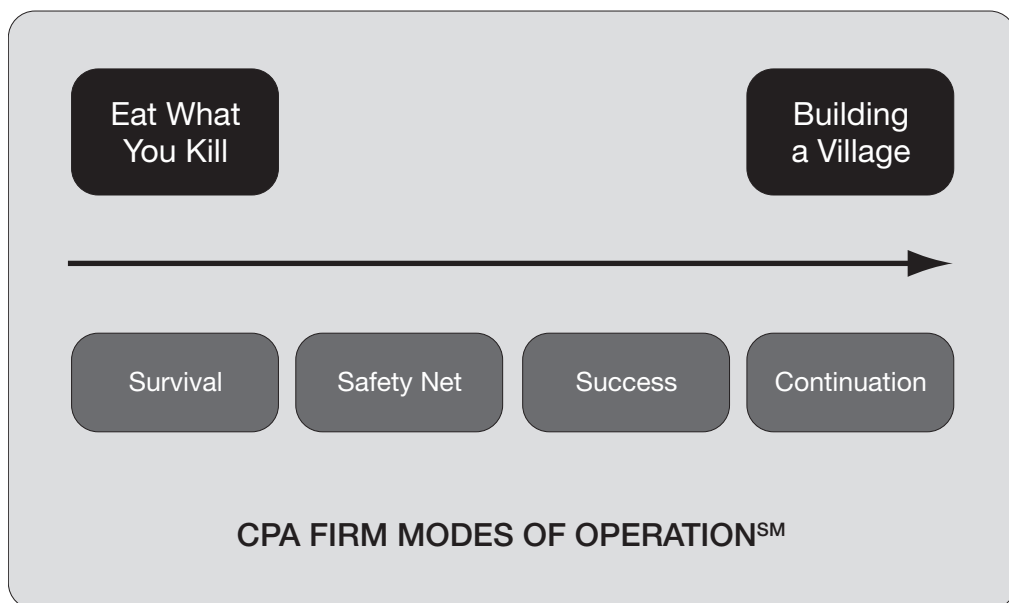
Quality succession management requires infrastructure—something in which few first generation firms have been willing to invest because the founding partners want to maintain the freedom of doing what they want to do the way they want to do it. Instilling policies and procedures may seem like changes that create a loss of creativity, a restriction of productivity, and a reduction of flexibility for our natural leaders. In reality, this may be a little true. However, for whatever small loss in freedom that occurs, it is far outweighed by the clear message sent to every partner and member of the firm that it is essential to work within the structure and be held accountable.

Sustainability is the key to succession management. Sustainability requires infrastructure that allows leadership to change without significant changes to leadership. Unless firms implement the kinds of changes we discuss in this section, fixing the retirement issues really won't have much effect after you leave because the likelihood of that firm being around to pay you is small.

This chapter focuses on internal transition. Internal transition essentially involves selling your ownership interest to other parties, either existing owners or future potential owners, within the firm. Over the years, most CPAs have assumed that they would work in a practice, become an owner, work some more as an owner, and then retire by selling their ownership interest to the other people in the practice. Although that has always been a

reasonable assumption to make, for many practitioners, the reality of this scenario has not matched up to their vision. Why? Because the partners and people in the firm are not supported by a structure and processes that can easily move beyond the founding fathers (typically, founding fathers are the original founding owners of a firm, or sometimes in a multidecade old firm, they are a few like-minded entrepreneurial, dominant owners who split off, took over, or bought out others to take over controlling interest). In short, most entrepreneurs default to building organizations custom tailored to suit and leverage their personal skills, and therefore, selling or merging the firm is the only real option because the organizations they build are too customized for anyone else to manage without them.

Operational Modes



A critical point to understand is that if you are trying to build your firm to operate successfully long after you are gone, the problem is less one of finding new leaders than it is about what the existing leaders will put in place that will derail and handcuff the success of those future leaders.

We have tried to clarify this by identifying common modes we have seen for running a CPA firm. Although we are not suggesting this is an all-inclusive list, we hope these definitions help loosely describe how your mode of operation could be helping or impeding your ability for a successful transition of your firm. The modes of operation, as we named them, are the following:

- *Survival.* In the initial stages of being an entrepreneur, we are driven by the instinct to pay for the roof over our heads and put food on the table.
- *Safety net.* Once we feel like our business will generate the resources required to cover our basic needs, we focus on building the business in a way to generate

enough cash to pay off our business notes, build personal and business savings accounts, and create a cushion in case times get tough.

- *Success.* Now that we don't feel desperate about our financial security, we start thinking about evolving our firm in a way that makes the owners and the people we are hiring want to work there. Additionally, the firm becomes an entity we think about protecting. The firm's success, reputation, and strength still are reflective of, and synonymous with, the owners in this mode.
- *Continuation.* At this point, our focus shifts from our success (where the owners have done well financially and are secure in their own accomplishments) to creating an organization that has its own institutional identity and that can survive without them.

So, at the "survival" level of operating a CPA firm, it is all about maintaining a firm that will pay the bills and provide food and shelter for the owner and his or her family. As the firm moves to the "safety net" mode, the owner tends to focus on generating enough cash each year to build a strong enough nest egg to create some financial security, both personally and business-wise. As the owner pays off his or her notes and builds cash reserves, he or she often shifts to a "success" mode of operating in which he or she starts paying more attention to creating the kind of environment that makes him or her and his or her people enjoy coming to work. This mode of operation also allows the owner to be proud to be a part of his or her respected organization. The owner efficiently builds the firm and its processes around the key people in the organization. For many owners, this is, the highest mode of operation they achieve because when many owners are ready to go, they just look for someone to buy them (with backup collateral) and they walk away. Finally, at the "continuation" level, the owner starts thinking about his or her life's work and he or she wants to start taking action so that the firm can survive and prosper long after he or she retires. For financial reasons, this is a critical mode of operation, especially if the acquisition or merger market is soft.

We realize that our analogy is very simplified, that all CPA firms don't go through these phases, and that even those that do don't necessarily go through them in a step-by-step manner. As you will see in a minute, we are trying to drive home what we believe to be some important points.

When you are just starting your firm, you aren't thinking about developing leadership. As we said, it is about paying the bills, making a living, and keeping the doors open. Once your bills are no longer an everyday threat, your focus shifts to setting aside enough money so that the anguish of living from paycheck to paycheck doesn't happen again. We want to build an organization that is solid enough to generate greater financial security. During these two modes of operation, the best and easiest way to fulfill these needs is for the owners to work hard, generate a lot of personal billings, depend heavily on their own skills, and build a support structure that leverages their time.

As their firms continue to thrive, owners start thinking about the culture they are creating and the concept that there is more to life than money (partially because they now have money). It becomes increasingly important to many entrepreneurs that they enjoy coming to work and that they are part of a well respected and highly thought of organization. The firm and the owners, although legally separate, have the same identity.

During this “success” mode, the firm continues to evolve into a kinder and gentler place to work. The choices being made every day are driven by the idea of enhancing the success and profitability of the organization while promoting the desired culture and living up to the current values and reputation of the firm. The fact that the organization has stated core values is usually a sign that the organization has moved beyond the “survival” and “safety net” modes. The strategy is to maximize the talents of people within the organization under the management and control of the founding fathers. Once again, in the “success” mode, it is about efficiency; we are not creating interchangeable parts but positions around specific people’s skill sets.

The final mode, “continuation,” is about separating the identity of the firm from the owners and building infrastructure and governance that transcends the founding fathers. This stage is very different from the other three stages because it often requires an organization to restructure and move away from the mode of operation that has been fundamental to current success. The “continuation” mode turns the business model upside down from the “success” mode because, rather than building the organization around the creativity, talents, and management skills of the founding fathers, it requires the founding fathers to give up some control, step back a little into the shadows, and develop people and infrastructure differently. The difference is that people are held accountable to roles and responsibilities and fill slots within the organization rather than the organization molding itself around the specific strengths and weaknesses of those same individuals. In the former, when a person leaves or is promoted out of a specific position, the next person will have to develop his or her behavior, actions, and skills to fit the opening. In the latter, the organization itself will have to be redesigned to optimize around the next candidate.

Once the founding fathers see the need to step back and stay involved, while taking a much less prominent and dominant role, they quickly balk at many of the systems that they built because they are not comfortable customizing the organization around specific incoming leaders and giving them the power they have taken. The founding fathers realize the trap they created by making themselves customized parts of a generic service organization. That is the key point: the systems in the “success” mode were built efficiently and expeditiously around specific people rather than organizational roles and responsibilities. Those systems typically fail when dominant players or controlling interests are removed from the system.

So, in the “continuation” mode, your objective is to set up systems of governance, operational processes, voting rights and privileges, accountability, compensation, and so on that revolve around interchangeability. For example, you don’t create the job description for the managing partner as if a specific person were filling that position but, rather, as if anyone elected would fill that position. If the powers, limitations, expectations, responsibilities, and accountability of a position are tailored to a specific individual, then you are likely operating in the “success” mode. If they are right for whoever is elected, then you are probably much closer to operating in the “continuation” mode.

In the “success” mode, the firm is not thought of as an entity that is an asset that needs to be protected, nurtured, and managed but simply a conduit for financial gain of the owners. Owners treat the entity as insignificant, with all the value being attributed to specific

people and their achievements. To move from the “success” to “continuation” mode, the founding fathers have to be visionary enough to realize that the long-term success (beyond them) of an organization requires that the entity, its governance, and its processes have been established in a way that it can manage around and quickly shed (terminate) a few owners who can’t move beyond the “success” mode of operation.

Cingoranelli and Reeb Case Study

Now that we have shared this concept, let’s apply it in a case study:

Survival:

Cingoranelli and Reeb (CR), a small firm in Texas, opened its doors in the ’80s. To cut costs in the beginning, they operated out of the apartment attached to Cingoranelli’s home. In the beginning, because they had just opened their doors, they looked for any work that would pay the bills and keep food on the table.

Safety Net:

As the firm thrived, the owners became much more selective regarding the work they accepted. They culled the clients who were difficult to work with and expanded the work that they enjoyed and that was the most profitable. As they built up their savings accounts, paid off all their notes, and drew higher salaries, they decided it was time to make even more money. So, they added employees, moved into a prestigious office space, and focused on building a team of people who would take them to their next level of success.

Success:

As people in the organization excelled in their positions, CR added them as partners. Although those partners were not deemed to have the entrepreneurial skills of the founding owners, the new partners were critical to getting the work done in a quality manner and on a timely basis. These new partners were important members of the team that CR did not want to lose, so enticing them with partner status and benefits seemed like a good investment and a manageable risk.

Within 10 years, CR had 6 partners: 2 founding partners and 4 hard working junior partners. Cingoranelli and Reeb each owned 35 percent of the firm, and the other 4 junior partners owned the remaining 30 percent (7.5 percent each). The 2 founding fathers, although benevolent rulers, were in total control of the firm, from management decisions to compensation to everything in between. The firm flourished. All the partners made good money, but Cingoranelli and Reeb made a lot more than the others.

The Chasm Between “Success” and “Continuation”

In the case study just presented, we are now at the chasm between the “success” and “continuation” mode of operating. Unfortunately, this situation is the most common scenario found in our profession. The problem comes now when Cingoranelli and Reeb want to leave. The governance model is in the hands of the two founding owners. The management

decisions and compensation allocations fall into the same system. This firm has been run to optimize around Cingoranelli and Reeb, not to optimize around the four junior partners. The junior partners have not been developed as leaders because as long as Cingoranelli or Reeb are around, these two are in control, and that's the way they want it.

The firm did not invest in creating a marketing infrastructure because Cingoranelli knew everyone in town and could bring in business almost at will. The firm did not push or even support the junior partners developing exceptional technical ability because Reeb was the firm's walking tax library. The junior partners were so busy over the years managing Cingoranelli's and Reeb's projects that they hardly had time to develop a professional network and were rarely put in key client situations to showcase their talents. Cingoranelli and Reeb have no doubt built a successful and profitable firm. Although it might be a cash cow, it is not much of an asset. The firm is not all that valuable because it is built around Cingoranelli's and Reeb's connections, books of business, and individual instincts.

For example, it takes time to develop a gut to manage a business. This is not a switch that is turned on and off. As a matter of fact, Cingoranelli and Reeb both paid a heavy financial price in their early years by making a number of bad mistakes to build their business instincts. However, they were unwilling to make those same kinds of investments in their junior partners—letting them learn through trial and error.

Probably the biggest mistake Cingoranelli and Reeb have made is in the governance area. Because they were rulers, albeit benevolent ones, the other partners never really had a say in the operations (maybe a voice but no say). Although the vote was a formal process, once Cingoranelli and Reeb stated their opinions, challenging the vote was useless because the decision was already made. Furthermore, Cingoranelli and Reeb always came to the partner meetings in sync with one another; they'd hashed out their differences one-on-one before they included the rest of the partners. In other words, although the firm was successful and profitable, it was not positioned to move forward without the involvement of the founding fathers.

Here are some of the common problems that crop up when trying to move from the "success" to the "continuation" mode:

- Ownership. Who gets what stock once Cingoranelli and Reeb retire?
- Would the remaining shareholders all be equal?
- If so, who would step up as managing partner?
- Would the new managing partner have support from the other partners to hold them accountable as Cingoranelli did, or would this current junior partner turned managing partner mostly fill a weak, figurehead position?

If Cingoranelli and Reeb were using the "continuation" mode of operating, a new managing partner would be in place long before either of them retires, with powers to hold all partners, including themselves, accountable. Ownership would not just get proportionately allocated but transferred, based on some performance metrics, to the most capable remaining shareholders. You see, Cingoranelli and Reeb brought in partners who allowed the two of them to be successful. Those junior partners have been acting as technical partners, not client service partners. In the end, a successful firm, in our opinion, can't be run by technical partners.

So, which of the four junior partners will step up as client service partners? This is a key question. Whichever partners step up (that could be any number from zero to four), the client service partners need to be in control of the firm. The torch has to be passed to the partners who understand that running a successful CPA firm is about managing clients, training staff, and retaining happy people. If you turn the firm over to technical partners, they often

- just push themselves to work harder to make up for any shortcomings.
- create a negative environment because they place a premium on people like themselves who work like mules and are less tolerant of work-life balance.
- create compensation models that are all about charge hours and personal billings, which pushes the firm back to an “Eat What You Kill (EWYK),” or superstar, model.
- don’t develop anyone because they themselves do most of the work.
- marginally care for clients. Although they take good care of clients when they call (that is the key), they operate as “order takers,” rather than being their clients’ most trusted advisors.

Another problem that often arises in this situation is that the junior partners have little to no chance of working together after Cingoranelli and Reeb retire. It is not uncommon to find that the four junior partners do not respect each other, might not trust each other, and might not want to even be partners with each other. Cingoranelli and Reeb ignored all of this when building the organization because they knew that as long as they were around to manage the situation, it was easily kept in check. Under the “continuation” mode, it is the responsibility of Cingoranelli and Reeb to deal with this now—long before they go. They need to run off the weaker or incompatible partners and not saddle the firm with this kind of ownership dysfunction.

A critical phrase included in the case study we presented really summarizes a foundation concept of the “continuation” mode: it is the responsibility of Cingoranelli and Reeb to deal with this now—long before they go. *This* is the operative word here. It includes anything and everything that needs to be addressed. We see founding partners leave their firms in such a chaotic state of governance that it would take a miracle for the remaining partners to stay together. In such a case, the founding fathers should have taken the firm apart years earlier so that those who want to stay together would have an opportunity to build something that can last.

Another classic case we find involves firms that have a talented consensus builder or peacemaker as one of the founding fathers. Once that owner leaves, the rest of the partners may have little, if anything, in common with each other because the retiring partner was the glue that held everyone together. Once again, the founding fathers should have realized that if it takes Herculean strength to hold the firm together, maybe it shouldn’t be held together.

How about small to midsize firms (usually between \$2 million and \$20 million in annual volume) that create executive committees to retain the decision-making power in

a few founding fathers? When these key people leave, they often have created a system of governance that worked for them but will fail for the next generation of leaders. This is not because the next generation of leaders is incompetent; it is the classic story of the father willing a business to his three sons all with equal ownership. Rather than willing the business to the son who is most interested in the business and best suited to run the company and finding other ways to compensate the other two siblings, the father avoids the conflict altogether and just gives it to all of them to fight over and destroy.

Generation after generation of owners avoids dealing with the problems they have created. The easiest way to deal with it is to sell off the firm to someone else and let it become his or her problem (the “success” mode alternative). For those who realize that this may be a weak bet in the future and want to consider the “continuation” mode as either their primary alternative or a strong backup, it will require a thought process entirely different from that used in the “success” mode of operation.

To summarize, it is common for retiring founding fathers to leave a cadre of partners at various stages of capability with voting rights misappropriated and in the wrong hands to assure a successful future for the organization. The failure in successful transition to the next generation of leaders isn’t nearly as much about the inability of the remaining partners, as it is about the processes, systems, and governance to which the next generation of leaders accedes, especially since that infrastructure was customized to leverage the specific individual talents and control of the departing founding fathers rather than the best way to run the firm.

How These Modes Integrate With the EWYK and “Building a Village” Models of Operation

We introduced the EWYK and “building a village (BAV),” or Operator, models of operation in chapter 1. We want to take a minute and discuss how the modes we’ve described here overlay those models.

The “survival” and “safety net” modes very clearly live within the EWYK model of operation. It is all about the owners, leveraging their talents, bringing in people to assist them, and so on. It is the story of the hunter evolving his or her skills as a hunter and becoming more proficient and effective in that role.

The “success” mode bridges the two models. We find the “success” mode existing in the late stages of the EWYK model (because firms are starting to emulate some of the BAV concepts of operating) and in the early stages of the BAV model. The “success” mode embraces many of the key concepts that are in both models. More specialization exists, but plenty of focus is still on the hunters. A stronger system of governance and accountability is in place, but governance is controlled by the founding fathers and accountability is focused on everyone but the founding fathers. The point is that you can find the “success” mode in both models. The “continuation” mode is only found in the BAV model. This mode is

about making the team stronger, processes that everyone is expected to follow, and governance that will hold everyone accountable. The “continuation” mode is about the founding fathers making themselves less important and operating in a way that will minimally change when people filling key positions change.

The Basics of Successful Transition to New Leadership

Now that we have taken a look at various modes of operation and seen how they apply to common operating models, let’s take a look at key areas that need to be addressed in order to support a successful transition to new leadership. We’ve covered one broad set of these issues—cleaning up your firm operationally for succession management—in chapter 3. In this chapter, we will discuss the following:

- Governance issues you must address
- Roles and responsibilities of owners
- Holding owners accountable
- Standard operating procedures (SOPs) to provide the infrastructure for the business
- Dealing with books of business, including transitioning from retiring owners
- Transferring and shifting ownership interests
- Developing your partners’ management and decision-making skills
- What you can start doing now to develop your people
- Cleaning house
- Conclusion

We believe these issues must be addressed properly for you to create sustainability at your firm. This sustainability is what will allow you to transfer ownership with the peace of mind that comes with knowing that the firm and the successor owners will continue to be successful in the future without you and that you will receive your buyout payments as expected.

Governance Issues You Must Address

The Problem With Most Entrepreneurial Firms

Most entrepreneurs haven’t developed other entrepreneurs to take over the firm when they ultimately decide to leave. What they’ve done is develop workers while running off anyone else with an entrepreneurial bent. They’ve built an EWYK model with a group of people hired to support them as hunters, but they’ve eschewed developing other hunters. In fact, due to the typically strong personalities and opinions often held by people who operate as hunters, the founding fathers usually view other potential entrepreneurial talents as threats to their way of doing things. This means that the firm is run by the entrepreneurial owner in a governance style often described as “an iron fist in a velvet glove” or a “benevolent

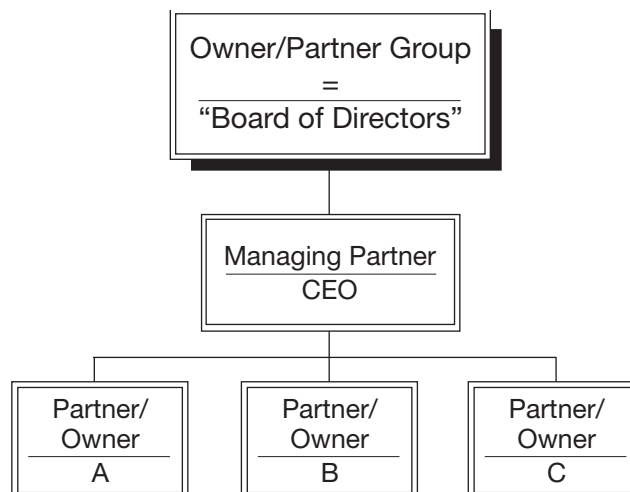
dictatorship.” This probably has allowed those owners with good business instincts to make a lot of money over the years. It hasn’t allowed anyone else the opportunity, however, to flex their entrepreneurial muscles and learn how to make good business decisions. As long as the entrepreneur has been involved, controlling everything the firm does, no one else needed to or has been allowed to make any significant decisions.

When a strong entrepreneurial leader leaves a practice, it creates a decision-making vacuum that can cripple or ruin a firm in a short period of time. Often, what we see without a properly thought-out governance structure in place when a long time leader leaves is a backlash reaction on the part of the remaining owners who vow to do things “differently” now that he or she is gone.

For example, in a firm with a strong, dictatorial managing partner, the remaining partners may choose to try a “softer” consensus approach to managing one another and getting things done, and usually, what happens is that nothing gets done. Although the outgoing partner may have been a dictator, he or she at least managed to get some performance out of the firm owners and staff. In his or her absence and in the maelstrom created by the decision-making vacuum, some decisions don’t get made when they should, and the decisions that do get made often are of substandard quality. Decision-making quality can suffer because ideas aren’t properly vetted, new initiatives aren’t properly fleshed out, and people avoid serious debate rather than risk being seen as confrontational.

Organizational Hierarchy

Setting up a robust governance structure doesn’t have to be as daunting as it might sound. It’s simply a matter of identifying who will get to decide or have a voice in what issues. It’s illustrated by delineating lines of authority as is done with organization charts. Following is an example of an organization chart for a small firm that doesn’t have separate departments for functional work groupings.



This chart shows the reporting relationships of the owners of the firm. The equity owners compose the partner group (what we refer to as the *board of directors*) to whom the managing partner or CEO reports. In turn, he or she has authority over each of the individual partners in their day-to-day activities. This structure, with some definitions of roles and responsibilities (discussed subsequently), will provide a foundation for proper governance of the firm. It's important to note here that we're using the term *board of directors* deliberately. When acting in the governance role, your owners, or partner group, need to function as a board of directors would function in any other business organization, not as a bunch of individual practitioners doing their own thing and not as a collection of managing partner wannabes, with each trying to micromanage the firm's administration. Therefore, when we use the term *board of directors*, we are referring to the partner group acting in a specific capacity. The partner group, acting as a board of directors, sets the overall direction for the firm and, within budgetary and policy constraints, holds the managing partner or CEO accountable for following that direction and hitting the appropriate metrics that define success under that direction.

The problem is that although this organizational chart would be common to the vast majority of multiowner firms, no matter how small, the interpretation of what this means would be as wide as an ocean. For example, in "success" mode firms, the managing partner or founding fathers take on the power and authority of the board of directors and then strip the board of the power and authority that was intended for this body. The founding fathers tend to create structure to give them the controls they want regardless of how they have to redefine these positions to make it work. However, although this damaged structure will work fine for them, it will become a huge impediment for success once the next generation of leaders becomes encumbered by it.

On the other hand, also in the "success" mode, it is just as common that after a strong managing partner retires, the next managing partner is stripped of all of his or her necessary powers and authority because each partner on the board of directors wants the right to occasionally be armchair managing partner of the day over issues that personally affect him or her.

Under the "continuation" mode, clear lines are drawn between these hierarchical levels, identifying the powers, authority, limitations, expectations, and responsibilities of each. Years of operating within the structure, respecting the structure, learning to trust the structure, and openly confronting those attempting to violate the structure is what ensures succession beyond the current leadership. In most cases, in order to implement the "continuation" mode, it takes strong partners willing to put the firm ahead of their own personal interests. Although this does happen, it doesn't happen nearly as often as it should. Could all entrepreneurs be as selfless and visionary as George Washington when he turned down the request to be made king because he saw that the less powerful role of president was in the best interest of the newly formed nation? He was able to see beyond himself and understand that, although he personally would gain more as king, he would position the country for likely abuse or chaos by those who followed him.

Proper Vetting of Ideas, Meeting Management, and Voting

You also must address other governance processes in addition to reporting relationships and lines of authority and responsibility. For a group to function effectively together in group decision making, it needs some meeting structure. It's no surprise to us that in many entrepreneurially managed firms, the partners have a litany of complaints about meetings, from "we don't meet often enough" to "our meetings are a waste of time" to "nothing ever comes of our meetings." This is because the meetings aren't properly managed, from premeeting agenda preparation to running the meeting to accurately documenting and timely distributing the record of the meeting (meeting minutes). Often, no agenda exists, and when it does, it isn't followed or not everyone had an opportunity to suggest items for it. The meeting discussion is not properly facilitated by the leader, so people either go on and on without coming to any decision or some items don't get much, if any, discussion. If someone seems to agree on a course of action, he or she doesn't necessarily vote on it to approve it. Yet, if someone proposes a course of action with which the rest of the group disagrees, then a vote is taken to vote it down. Under these circumstances, a vote is the equivalent of a public lashing and something that only happens when you have raised a bad idea.

Owners need to get used to raising, discussing, and defending issues in the group in a way that keeps egos out of the process and allows for the development of even better ways of approaching things. This means that you should look at beefing up your meeting procedures, including using parliamentary procedures to make motions and to call for discussion and the vote. You also need minutes that document the decisions made, accountability assignments, and due dates for any actions that you agree to take. If someone wants to raise an issue at a meeting, he or she is free to do so within the parliamentary procedures being used. The issue will get discussed and a vote will be taken. If it doesn't pass, the group moves on. This all helps create a decision-making model that allows for open discussion and requires new proposals to be conceptually defended. It creates better thinking and better meetings. It also avoids the all too common problem of a firm's decisions being made by the vocal minority instead of the majority of owners.

Roles and Responsibilities of Owners

Clearly defined roles and responsibilities of owners are closely related to the governance structure we just covered. The reason this is so important is that a typical entrepreneur has a pretty good instinct and knows how to get things done, make money, and have some fun in business, but not everyone has such highly developed instincts. The owners need a clear understanding of their responsibilities, relative to others, as well as what's expected and not expected from them. Defining roles and responsibilities helps you set boundaries for your people, and in doing so, helps them function effectively and productively.

Typically, for an organization such as the small firm represented in the previous organization chart, roles and responsibilities will be identified for each of the different positions on the organization chart. For example, the board will set the overall direction of the firm

and approve major policies and procedures. It oversees the managing partner or CEO. The managing partner or CEO prepares business plans designed to move the firm in the direction established by the board, and the board approves the business plan and budget. The managing partner or CEO then implements the plan within circumscribed boundaries set by his or her roles and responsibilities. In doing so, he or she oversees the individual partners or owners, and they report to the managing partner or CEO. Thus, the owners in a CPA firm will, most of the time, be functioning as direct reports of the managing partner or CEO, following firm-prescribed SOPs and policies, with each working to attain the personal goals set collaboratively with the managing partner or CEO. In this role as a line partner, they are more or less doing what the managing partner or CEO suggests. Contrast this with their role as members of the board of directors. As board members, they set strategy, policy, and direction at a very high level. They hold the CEO responsible for obtaining the desired firm-wide results, which then leads to the CEO assigning specific operating goals to the line partners, with said goals supporting the firm's overall strategy.

Holding Owners Accountable

Some CPAs have become used to doing things their way in an environment with little to no accountability. They've flown under the radar for long enough that it's an assumed cultural value at work. However, once you institute a formal governance structure with roles and responsibilities for everyone, these people will need to be held accountable. If you take your governance structure seriously, your board will hold the managing partner or CEO accountable, and he or she will hold individual partners accountable. Without accountability, the firm doesn't have much chance of moving in a common direction. The roles and responsibilities for each person help define accountability, and your compensation system helps enforce accountability.

To really make this all work, owners need clear expectations and goals, and they need to have some meaningful portion of their compensation at risk for meeting those goals. Their goals need to be tied to the firm's overall strategic goals. If partners do what they're supposed to do to help the firm move toward its vision, then they receive incentive pay for their actions. If they refuse to be held accountable or if they don't meet their goals, then they don't earn the incentive pay. It's really pretty simple. People usually will do what they get paid to do and pay much less attention to activities that don't generate compensation for them. How much of their compensation should be at risk? We suggest about 40 percent to get their attention, of which about one-half of that or a little less should be at the sole discretion of the managing partner. (We refer to this as the *managing partner discretionary incentive*.)

What are some elements of a compensation and incentives system? In a recent survey on succession planning that we conducted for the AICPA,¹ we found that firms are rewarding a variety of different types of performance. Following is a list of some of the more common elements of compensation that multiowner firms have been using recently.

¹ AICPA. 2008 PCPS Succession Survey. The Succession Institute, 2008.

Elements of a Compensation System	2008	2004
Salary or base draw	82%	86%
Ownership percentage	48%	48%
Size of the owner's client book or fees managed	34%	38%
New business developed	34%	28%
Billable or collectable hours	32%	32%
Profitability of book	30%	N/A
Performing certain identified firm functions (managing partner, department heads, chairing committees, and so on)	29%	28%
Growing the business with a current client	21%	17%
Capital accounts	20%	15%
Training and development of staff	19%	N/A
Cross-selling other services into your client base	14%	11%
Business transferred to other partners or managers	13%	8%
Profitability of department	11%	N/A%
Leverage of work being done (ratio of partner to staff work)	10%	N/A%
Client satisfaction goals	9%	5%
Other	9%	15%

N/A=Not asked in that year's survey

Depending on the firm, some of the pay components in the preceding chart are treated as objective measures that become part of the firm's partner compensation plan. At other firms, some of these metrics might be included as part of individual goals set between the managing partner and the line partner. In the latter, these goals would be covered under the managing partner discretionary incentive previously introduced. Firm-wide metrics typically cover the behaviors a firm expects of all partners. Customized metrics tend to fall within the managing partner discretionary incentive and are used to accomplish specific strategic goals, which are divided up among the partner group based on strengths or job responsibilities.

Many of you may have had an initially negative reaction to this particular suggestion and that's possibly because you immediately thought of a managing partner you knew or know who abused his or her power and violated the hierarchical system we are describing. So, let's make this clear. The managing partner works with each partner to establish personal goals that support the overall firm strategy. Once these goals are created, then the managing partner has the sole decision about whether those goals were achieved and the appropriate compensation earned. If a partner has a problem with the allocation, then he or she has the right to go before the entire board and present a case to see if the board will overrule the managing partner's assessment. As you can see, a process exists; however, here is our warning: the board needs to take on the attitude that the burden of proof rests with the challenging partner and that, unless a clear oversight occurred, it will support the managing partner. It is the job of managing partner, not the board, to manage the partners. As soon as that structure is violated, accountability tanks very quickly.

The whole point of compensation is to drive the implementation of your strategy so that bigger rewards are available for everyone. Clearly, more money should be attributed to those who facilitate the firm reaching its desired destination. Keep in mind that the activities you reward next year will likely be different than the activities you rewarded this year. Your incentives need to focus partners on collectively achieving the firm vision, and the year-to-year emphasis normally changes because we're living and working in a dynamic environment. For one year, the emphasis might be on cross-selling services to increase staff utilization, but for the next year, the emphasis might be on working to improve staff realization through better staff training and project efficiencies.

SOPs to Provide the Infrastructure for the Business

SOPs represent the agreed-upon methods of dealing with matters of importance to the firm. Although the SOPs likely will include areas such as client and engagement acceptance, quality control, billing, and collections, they really can and should address a much wider range of issues, including matters already covered in this chapter, such as the following:

- *Roles and responsibilities and duties of the partner, managing partner, and the board or partner group.* As previously mentioned, these address who is responsible to whom for what activities and objectives and under what constraints.
- *Voting rules for one person, one vote and equity ownership interest voting.* A vast difference exists between using one person, one vote and equity ownership interest voting, including the following:
 - On the one hand, using one person, one vote voting allows everyone to have an equal say, regardless of how much operational involvement they have through the number of client relationships they manage. It allows new, junior partners to have the same voting weight as seasoned, experienced partners. We believe operational issues are best reserved for this type of voting.
 - Voting by equity ownership interests, if your equity is properly distributed, allows the more senior client relationship partners to have more weight in key decisions than either junior partners or technical partners. Some decisions, such as agreeing on admission of new partners, probably should be done using one person, one vote voting. Others, such as those dealing with retirement provisions, in our opinion, are best decided on ownership equity votes.
- *Compensation plan.* To allow your managing partner or CEO to hold the rest of the owners accountable and to allow your board to hold the managing partner or CEO accountable, explicit operational goals need to be in place that support the firm's strategy. These goals need to drive the compensation plan, which will change from year to year depending on the firm's needs.
- *Other SOPs.* Other SOPs might include the following:
 - Valuation for partner admission or withdrawal
 - Transitioning business at ownership transfer

- Partner admission and termination
- Partner death and disability
- Partner capital requirements
- Votes required for mergers

The foregoing list represents a limited set of examples of SOPs that will provide the infrastructure your firm needs to function without you or with another entrepreneur managing it through your sheer willpower or dominance. SOPs take some of the internal guesswork out of running the firm through the context they create. In doing so, they provide the structure to allow for effective leadership, governance, decision making, and accountability. They also provide a modular approach to addressing legal agreement provisions with clarity and simplicity.

Dealing With Books of Business, Including Transitioning From Retiring Owners

Balancing Books of Business

When we discuss balancing books of business in the “continuation” mode, we’re focusing on creating a culture around the firm’s clients, not a partner’s clients. Although partners are assigned to manage specific clients and books of business, they are merely custodians of those clients until the firm decides otherwise. The objective is to create an organization dedicated to leveraging its talents to best serve its clients rather than creating individual empires. If you haven’t already addressed this, you’ll need to look at balancing books of business of the owners as you go forward in your retirement and succession planning.

What’s an appropriate balance, you might ask? Book sizes don’t have to be exactly equal—they just need to be similar in size. For example, your partners in tax will not likely average the same book size as your partners in audit. If you consider that the average book size for partners in tax is \$1 million, then a partner with a \$1.5 million book should be transitioning clients to the partner with a \$600,000 book. Although no rule exists on this, we believe you should try to keep the gap in book sizes within a similar line of business to approximately \$200,000.

In the “success” mode of operation, managing book size is not a big deal. Why? Because the founding fathers have the biggest books and, therefore, the biggest compensation. Usually, several junior partners work on their clients. This is a successful approach all over the country, until it is time to retire or be paid for what the firm has built.

By constantly balancing books in the “continuation” mode, you allow the bigger book partners to free up time, and they will likely go out and generate more opportunity and revenue for the firm. By shifting business to the smaller booked partners, you force them out of the role of overserving their clients because they have to delegate and get more people involved to handle a greater work load. This forces them to engage and develop more people in the firm or, at a minimum, support the training initiatives to accomplish this. If you have a partner who can’t handle an average level of book, then we question whether he

or she should be a partner at all. If it is your decision to keep him or her as a partner, then we would suggest he or she be tagged as a technical partner and that his or her influence in firm decision making always be kept in check by those people who are the average or higher client service partners (unless, of course, these technical partners evolve to become average or better client service partners).

As you can see, the focus of this mode is to make all the partners pull their share of the weight of the firm's success and to not let those who can't do so live under the radar. By taking this approach, you will be surprised how many partners will step up. You also will be surprised by the number of partners who, over many years, have slowly gained power and influence (equity ownership increases) but don't pull their weight. This situation needs to be addressed early on so that weaker partners can either be run off or their influence minimized in overall firm strategy and decision making. This is critical so that you don't saddle the next generation of leaders with albatross partners who live to block necessary firm initiatives.

Other Books of Business Issues

Transitioning clients from retiring owners to other owners is always a hot topic. Who should take over those client relationships? Consider factors such as the need for any special industry knowledge or other technical background required of the new client service partner for particular clients, as well as personality and style compatibility. Also critical is considering relative book sizes pre- and post-transfer to ensure that logical and proper book balancing continues into the future. We cover transitioning of clients and a process to follow in chapter 8.

While you're looking at the various books of business in your firm, take another look at the nature of the books of business being held by each owner. For example, do you have one owner doing litigation support services pretty much exclusively, with little to no staff leverage? If so, when he or she leaves, how will your firm buy him or her out? If there's not a recurring book of business that's capable of being leveraged through other people, what value is he or she leaving behind? There needs to be an income stream from work to allow your firm to pay him or her off. Unless you can count on the vast majority of a partner's clients staying with you, where will you generate the cash for his or her buyout payment, short of reducing remaining partners' pay?

Some situations exist in which a partner consistently generates new business from referral sources, and as long as these relationships are transitioned, then all may be OK. In the case of the litigation support partner working alone (or being the only one working directly with the lawyers) it is likely that not only will the referral source stay with the retiring partner (in other words, he or she will continue to do that kind of work), but the clients were never hiring the firm, only a specific person. Therefore, no value was being created for the firm by this work, just value accruing to the individual partner.

Under the "success" mode of operating, this is fine because the founding partner was doing what he or she wanted and was making good money. Because they are likely operating in an EWYK environment, the firm and the partner probably did fine.

Under the "continuation" mode, this partner should have been required by the managing partner to develop a plan to build this service into a two- or three-person department

within a three-year period where at least two people were doing testimony work, or that partner should have been asked to redirect his or her time to support some other service more sustainable by the firm. The firm in the “continuation” mode is not in the business of building spin-off services by funding them until they’re profitable and then being held hostage by them when they are finally successful. As we said earlier, the “continuation” mode of operation is about putting the firm first and protecting it.

If you are functioning under the “continuation” mode, your partners may even have an opportunity to consider taking a sabbatical. Yes, you read that right; larger firms have been increasingly embracing the idea of sending partners away on brief sabbaticals (anywhere from one to three months, with some being of longer duration). This could provide a variety of benefits because it requires that clients truly be treated as clients of the firm, not just as clients of one owner, so client transitioning for any future departure of an owner might be more easily accomplished. The interim client service can be handled by another line partner, or better yet, that responsibility can be given to an up and coming senior manager who can play the role of a partner for a month or two so others within the firm can see what he or she has to offer as a partner. By having other firm members working more closely with these clients in the interim, clients are not as exclusive to one partner because others have to step in, which often creates opportunities to improve client service, provide additional service offerings, and build client loyalty. A key justification to this investment is that the person who’s on sabbatical gets a chance to recharge his or her professional battery. Given the demands of being a partner in our profession, this recharge can bring renewed energy to the firm. Under the right circumstances, it seems that everyone comes out a winner in this situation. The firms that currently offer this program are amazed at the reaction, not only internally but from clients, as well. Clients seem to appreciate the partner taking a sabbatical and welcome meeting others from the firm and getting their perspective on their business. This is a trend that’s just starting to garner some attention and momentum, so stay tuned.

Transferring and Shifting Ownership Interests

General Patterns We See in Ownership Interests

What will most likely happen in your firm if you’ve treated your junior partners as highly qualified helpers, relegating them to the role of managers on your jobs? Remember, for most entrepreneurial senior partners, it’s all about their books, so they look for good technical execution in the people they bring up through the partner ranks. Consequently, they create a class of technical partners with little or no client relationship training, client development training, duties, or skills. With what these people have been assigned to do, there’s been little perceived need for them to expand their decision-making ability, firm management skills, or client relationship activities, so these technical partners more or less manage projects and crank out billable work. As the founding fathers retire one by one, these junior partners, who haven’t been developed to be good general managers, slowly gain in their

ownership power as they become the new senior partners. Because they have made a good living working hard, doing a lot of the client work themselves, and being valued for their technical ability, it is no wonder that these ethics and values start permeating the core values of the firm. This next generation CPA firm often moves away from an entrepreneurial mind-set and becomes strongly entrenched in the EWYK model, often taking steps backward in the personnel training and development progress made during the later stages of the “success” mode.

So, although you can argue that this firm made a successful leap in leadership from the current owners to the next, the leap is often backward instead of forward. The leap is often one of stagnation rather than revitalization. The key is that although the founding fathers in the “success” mode can run a very profitable firm filled with technical partners, once they retire, they can’t just turn the firm over to those technical partners and expect it to have a good chance of future success. They have to turn the reins of ownership over to client service partners who will replace them.

Who Should Control the Ownership Equity of Your Firm?

Our point here is that your firm should be controlled by the client relationship partners, not technical partners, because the client relationship partners are the people who are maintaining satisfied clients, which allows the technical partners to come to work every day. Take a look around you outside the accounting profession. Every successful company, while maintaining excellent operational capability, is managed with a marketing focus. That’s what strategy is all about—where your market is headed and how you’re going to stay relevant to service it, make some money, and have some fun.

Under the “success” mode, the founding fathers give out equity to keep their technical partners working and producing at a high enough level for them to maintain or increase their (the founding fathers’) annual earnings. When it comes time to transition the business, the founding fathers will try to find new entrepreneurs to replace them, which often results in selling or merging the firm.

Under the “continuation” mode, those partners who step up and embrace key required partner roles are given or sold more ownership and put in more influential decision-making positions than those who just want to crank out the work and do their own thing. It’s not about giving control to the business development partner or the most dominant type-A partner but, rather, to those who do a good job of being client service partners. Partners don’t have to be born with this skill; the firm will gladly pay to train partners to be of the highest value to the firm. The “continuation” mode takes the job of evolving people so that they are skilled for the job they want to be promoted into some day.

This is where the rubber meets the road for the founding fathers regarding the next generation of leaders. Will they effectively address the requirement for partners to embrace and live up to important roles and responsibilities within the firm? For those who don’t, will the founding fathers ensure that these partners are at least relegated to minimal influence at the firm’s decision-making table? This is simply about ownership interest allocation and is a

subject that is difficult, stressful, and confrontational, which is why it is so often ignored and garnished with unrealistic hopes that everything will work itself out.

Who Should Become Owners in Your Firm?

We probably should take a moment or two here to discuss the issue of identifying potential owners and admitting them to ownership in your firm. When should you not make someone an owner? Well, as we see it, if the person clearly doesn't embrace the firm's core values or if he or she is an unproven quantity in terms of core values, technical ability, client service ability, or the ability to work within your SOPs, you shouldn't be making him or her a partner, especially not just for the sake of keeping him or her around. With proper management and development of these people, you'll be able to turn them into known quantities and determine whether and when they should become partners. In *The 2008 PCPS Succession Survey* we conducted for the AICPA, here's what we learned about current practices relating to admission to ownership.

Identified and Formalized Requirements for Ownership	
We do not have formal written requirements but, rather, informal ones that change based on the perspectives of the current owner(s).	70%
We have identified crucial competencies that must be met in order to be considered for ownership.	33%
We have identified and documented minimum subjective qualities and characteristics that must be met in order to be considered for ownership.	24%
We have created a nonequity partner track to make sure the new partner(s) fits culturally with the firm before becoming an equity owner.	22%
We have an identified and documented a minimum client book size for the potential owner(s) to meet in order to be considered for ownership.	11%
We have identified a net revenue per partner requirement, so partner slots open up as the firm reaches revenue thresholds.	11%
We have an identified and documented minimum new business development amount for the potential owner(s) to meet in order to be considered for ownership.	6%
We have identified and formalized the requirements to move from nonequity partner to equity partner.	6%
Other.	3%

As you can see, 70 percent of the responding firms didn't have formal, written requirements for admission. However, the preceding table will give you some idea about what some firms are looking at in making these decisions. From our perspective, prospective partners should be capable of being groomed to manage larger books of business than they've probably been accustomed to seeing in the past. (More on these trends is covered in chapter 2.) They should have the desire to work on developing the people within the firm, together with the ability to function effectively within the firm's institutionalized SOPs and approach to marketing and business development. They don't need to be rainmakers; they need to be people developers who want to understand their clients' needs, concerns, opportunities, and challenges. They also need to be of high moral character. Don't do business with people you can't or don't trust, either inside or outside the firm.

Career Paths for Prospective Owners

Once you've identified people with high potential for future ownership opportunities, what should you do about putting them on a developmental path to get them ready for ownership? We'll cover some of those steps next. (We cover more on this topic in chapter 3.) What we're talking about here is first identifying the skills and competencies that your firm needs and will need in the future from its partners. Next, identify formal and informal training and education, coaching and mentoring, experientially-driven job assignments, and leadership opportunities to bring out the best in them. A variety of training options are available that focus on the people and project sides of management, and we predict a growing number of these offerings in the future.

Appendix A, "Shareholder-in-Training Program Checklist," adapted from *Securing the Future: Succession Planning Basics*, outlines the steps you should take in developing your partner-in-training program.

Developing Your Partners' Management and Decision-Making Skills

You need to leave your firm in better condition than when you purchased or founded it. This means that you need to be developing your partners to help them become better than you. This often creates a huge shift in cultures, from building a client base to building competent, energized leaders to take over the firm. It's the difference between making yourself better and making those around you better.

In chapter 3, we briefly covered some steps that CPA firms can take to ramp up their people development in general, including identifying and training for specific competencies needed for success in the business and at your firm, more frequent interaction with your people on development and career-pathing, and ways to close the skill gaps. All of that applies to partners, as well. In this chapter we're referring to the need to allow your partners to begin to make more decisions.

Proper structure, policies, and procedures also will help you develop your junior partners. If you want your partners to be able to take over when you leave, you need to invest in small losses now and let them learn how to lead while you are still around to help them avoid big mistakes. In other words, let them make mistakes commensurate with their positions. You need processes that force these younger partners to formalize their exciting new ideas into a business plan model that challenges them to think through everything, from service launch, marketing, talent development, and service delivery to client satisfaction, within a planned time frame and budget. This requires infrastructure, which is something in which few first generation firms are willing to invest and put in place because the founding partners just do what comes naturally. It also requires deliberate, aggressive training and development of your people at a level that few firms have embraced to date.

In the succession survey² we did for the AICPA, we asked CPA firm owners what they presently are doing to develop future leaders at their firms. Here's what they told us they have been doing.

Actions Taken Currently to Develop Future Leaders	Multiowner Firms	Sole Proprietor
Identification of, and training for, specific competencies	75%	53%
Informal coaching by an assigned partner	56%	42%
Formal training or education in delegation and supervision	44%	26%
Formal training or education in interpersonal skills	36%	17%
Experiential assignments chosen to develop competencies	25%	21%
Formal mentoring program	24%	16%
AICPA or CPA association formal leadership development program	17%	4%
Formal partner-in-training program	15%	6%
Coaching by an outside consultant	14%	4%

When you think about this in the context of adult learning, these responses make sense. In addition to reading to get a cognitive understanding of a matter, adults learn by doing (practical application). That's why it's so important to provide developmental assignments, in addition to informal and formal training. That's also why, in addition to implementing infrastructure to force the younger partners to formalize their business thinking, you need to provide coaching and mentoring in concert with other training and development opportunities.

Your people are the future of your firm. You must invest in them to help ensure that your succession planning is successful. Unfortunately, our experience and the succession planning survey previously mentioned, show that many CPAs aren't investing in the future. The composite responses for all firms answering the survey showed that approximately 60 percent of them are spending less than 2 percent of net revenues on continuing professional education and training. This appears to be a very big disconnect.

We've seen cases in which the senior partners expressed a sincere interest in helping their junior partners learn some new skills, which is good, but sometimes, that is as far as it goes. The senior partners believe that all they need to do is train and "fix" the junior partners, and everything will be fine. The problem with this line of reasoning is that the senior partners often need to learn (and apply in practice as changed behaviors) as much about people management, interpersonal skills, delegation, and communication as their junior partners. The senior partners often take the position that they don't need to change—everyone else does. It's never too late to learn a few new skills and approaches.

Additionally, how many times have you or somebody you know come back from some eye-opening training and tried to apply it back at the office, with little or no success? That's another common problem. You can't continue to operate under the "we've always done it this way" mode and expect a junior partner to come back and achieve any significant

² AICPA. 2008 PCPS Succession Survey. The Succession Institute, 2008.

transfer of training. The “way you’ve always done it” mode will stand in the way of ongoing, active, and practical learning and development. Stated differently, you need to clean up your practice to allow the remaining partners the opportunity to develop their strengths while the practice continues to grow profitably.

Under the “success” mode, founding fathers are looking for their replacements to be images of themselves. (They shouldn’t have to train anyone because no-one trained them.) Besides, if talented leaders don’t emerge on their own, then they will just sell the firm out from under the other partners.

Under the “continuation” mode, every partner, manager, senior executive, and staff member is working on developing their replacement. Succession and transition isn’t about a few key positions at the top but about filling positions everywhere. For anyone to move up in an organization, someone has to be ready to step in and take their place. Developing your replacement in this mode is not something you do when someone is a couple years from retirement but something everyone understands is part of their annual job responsibility. It is a simple philosophy: if you want to move up, you need to have someone ready to take your place.

What You Can Start Doing Now to Develop Your People

Developing future leaders is not just about looking for ways to fill the managing partner or CEO slot when the time comes. It really entails a high level, strategic view of developing a leadership pipeline. This involves creating processes to develop people throughout the firm at all levels as you continually improve everyone, making the firm as a whole a stronger organization. People development is your most important job as an owner of a CPA firm, and developing the future leaders of your firm is something you must do with a conscious, deliberate approach. We’ve provided a brief checklist with some food for thought on the business of leader development as appendix B, “What You Can Start Doing Now to Develop Your People.”

Cleaning House

No discussion of changes required for your firm to be succession ready and tee up an internal transfer would be complete without addressing the issue of dead weight partners and employees. Most of us have probably had the misfortune of working with someone like the character Wally in the Dilbert comic strip. He’s the guy who doesn’t do much. He doesn’t add value and doesn’t help others out when they need a hand—in short, he’s someone who’s not pulling his weight and who may even be detracting. You, as a strong-willed entrepreneurial owner, may have been able to manage your Wally over the years and get enough production to justify his or her position, but when you’re gone, don’t think that the remaining partners will be able to manage this person. It’s not going to happen. This is

partially true because, by that time, your Wally will have more power and authority through his or her equity rights than he or she deserves or has earned.

If you have partners who are not acting like partners, who avoid client relationship building like the plague, or who don't want to be held accountable, get rid of them now. If you have technical managers who are not pulling their weight; who, at best, are not running off any good clients; and who, at worst, are not doing anything to help cement client relationships on their projects and are not lifting a finger to develop others in the firm, get rid of them now. Don't saddle the remaining partners with people with inadequate skill levels, people who don't care enough to get better, or people who refuse to change their behaviors for the good of the firm.

The tone is set at the top of an organization. Do you want to create and maintain a professionally challenging and rewarding culture centered on client service, problem solving, and adding value, or do you want to create and maintain a culture centered on a lack of accountability and no consequences that is characterized by "at least he or she is a body and gets some work done;" "he or she is not very good, but better than nothing;" "as soon as we hire enough staff, we will get rid of him or her;" or "he or she's a problem, but we have bigger problems to deal with right now"? The choice is yours. These are common, initial responses when we suggest that changes be made. Short-term pain is often required for long-term gain, but it's well worth it. Do you think that the other, less senior people in your organization can't or don't see the inadequacy of performance and corresponding lack of consequences right now? How will you ever build sustainability on this kind of foundation? Although you might be making a great living, we can only imagine how much more successful your organization could be without the dead weight you have allowed to remain simply because you feel like you can handle them.

Conclusion

Before you leave your firm, you need to take a look at the issues we've raised here, including looking at who owns what interests in the firm and how much they presently own, compared with how much they should own. If you want the firm to continue successfully, make sure that the right people have the appropriate amount of ownership interest and that you have the governance structure to support them as they continue without you.

Ultimately, you need to give up some power and control in order to allow what you are setting up to endure beyond you. You want to do it before you leave so that you can still influence the organization while it is making its way through some uncharted territory. Ultimately, for most CPA firms, your retirement payout rests in the hands of those who follow you. So, don't just leave your partners with long standing, deferred organizational and human capital maintenance when you depart. Give them a better chance for success with the opportunity to lead within a structure that makes sense for the future, not one that makes sense for you.

For many retiring entrepreneurs, the shift in ownership and control when they leave presents the most vulnerable, dangerous position their firm will face. The owner on whom

the firm has depended for key decision making will no longer be in a position to drive the firm and related outcomes. Without adequate advance preparation that includes installation of governance infrastructure and partner development for the incoming leadership, the firm and remaining owners will be operating at the edge of a crevasse, and a fall from that edge could be lethal to the firm. This truly requires adequate advance preparation and consideration, and although it's complicated at times, you must address it. As you might guess, you need to think through what steps are necessary to move you from the "success" to the "continuation" mode, and the sooner you take action, the better.

Readying your next generation of leadership requires important developmental components, such as outside training, on-the-job training, mentoring, coaching, and constantly elevating trial-by-fire experience. Most firms we work with are starting to make good progress in this direction, and our training and development and shareholder-in-training checklists should be a good reminder of steps to take and issues for focus. However, although this development process is a very important part of the equation, the points we focused on in this chapter are the ones most often overlooked and, if handled properly, will be significant steps forward toward operating your firm in a "continuation" mode. Too often, the discussion is about the inadequacy of the firm's next generation of leaders. The point we wanted to drive home is that, in our experience, the disconnect is less about the next generation's abilities and more about the overall situation (policies, processes, governance, ownership split, and so on) they inherit. This is all easily fixable. It just requires you, the founding fathers, to address this now, confront the issues you know need to be resolved, and make sure your weaker players are not in a position to spoil the future success of your operation.

Appendix A

Shareholder-in-Training Program Checklist

This checklist was created to stimulate your thought and provoke your thinking regarding the creation of a shareholder-in-training program at your firm. It is based on four broad steps with detail issues to consider under each step. There's no one right or wrong way to do this, but this outline can help you get started in your process.

Step 1: Identify Program Structure. Selecting and developing prospective firm owners (referred to in this document as *shareholders*) is not a stand-alone issue. For it to be successful, it has to integrate with many other processes. Following are some of the basic questions you should consider as you develop your owner-in-training program.

Issue	Assigned To	Date
a. How are potential shareholders selected?		
b. What are the requirements that have to have been met in order for someone to be nominated for the shareholder-in-training program?		
c. How does the firm decide how many potential shareholder candidates it can accept? In other words, just because a CPA appears to be shareholder material doesn't mean that it makes sense for the firm to admit another shareholder. What process identifies the need for or the "making room for" a potential new shareholder?		
d. What changes (job duties, expectations, compensation, and so on) occur once a person is admitted to the firm's shareholder-in-training program?		
e. What alternatives are there for a person nominated for the shareholder-in-training program who declines the offer?		
f. How long does it take to go through the shareholder-in-training program (does it take a minimum period of time, is there a maximum period of time, can someone stay in it indefinitely, can someone be kicked out, and so on)?		
g. Is there any status change for someone entering a shareholder-in-training program (that is, new title, added to a leadership group, public announcement, and so on)?		
h. Is there more than one shareholder definition (for example, technical shareholders, client relationship shareholders, nonequity shareholders, and so on)?		

(continued)

Issue	Assigned To	Date
i. How are annual goals and expectations of shareholders (personnel in general) established, monitored, and evaluated?		
j. Are there minimums for being a shareholder (book size, project management skills, personal billings, years of experience, and so on)?		
k. How are potential shareholders developed (education curriculum, training, skills, project management, leadership, becoming aware of internal firm issues and matters, management, and so on)?		
l. How are potential shareholders mentored and evaluated?		
m. How often do the shareholders-in-training receive formal reviews and feedback rather than reviews and feedback just from their mentors?		
n. What happens to shareholders-in-training who never make the cut?		
o. How long can a potential shareholder operate in this phase before the "in" or "out" decision is made?		
p. How are potential shareholders field tested (put in action to see how they respond in shareholder situations)?		
q. When the day comes that a shareholder-in-training is deemed ready to make the next step, what is the process for that to occur (for example, nomination, denial, postponement, acceptance)?		
Step 2: Identify Shareholder Abilities Needed. To begin identifying the shareholder abilities needed at your firm, you need to be able to clearly answer the following three questions.		
Issue	Assigned To	Date
a. What are the job duties of a shareholder?		
b. What are the characteristics that a shareholder should possess?		
c. What are the competencies expected from a shareholder? Here are some of the common broad categories that many firms tend to look for in characteristics and competencies of shareholders: <ol style="list-style-type: none"> 1. Character 2. Client relationship management 3. Coaching and mentoring 4. Commitment to the firm and selflessness 5. Communication 6. Execution 7. Developing a following 8. Industry knowledge 9. Job competence 10. Judgment and decision making 11. Leadership image 12. Leading change 13. Management abilities 		

Issue	Assigned To	Date
14. Practice development 15. Problem solving 16. Project management 17. Staff relationship team building 18. Technical skills 19. Training plan 20. Work ethic 21. Vision and strategy		
Step 3: Develop Performance Evaluations. Once you have identified shareholder characteristics and competencies, another key step is the development of a performance evaluation process. This includes personal goal setting, personal development programs, evaluation, mentoring, and so on.		
Issue	Assigned To	Date
a. Start by identifying and establishing (at least annually) specific objectives for each of the areas you have identified as measurable competencies or performance objectives.		
b. Have your shareholders-in-training perform self-evaluations of their performance against those objectives, answering questions such as the following: 1. What have they done this year to achieve or make improvements in each area? 2. How do they think they have improved? 3. How would they rate their performance or accomplishment in each area? 4. What did they and didn't they achieve and why? Additionally, they should have room to expand on what they plan to do to make headway in those areas in which they fell short. 5. How would they rate their overall performance?		
In addition to the preceding step (b), consider the following steps:		
c. Have each person evaluated by people for whom he or she works, peers, and direct reports. This creates a 360 degree assessment that will provide additional, valuable insight.		
d. Use an assessment instrument for the 360 degree process that measures characteristics and competencies necessary for success, with questions such as the following: 1. Does this person confront low performers?* 2. Does this person try to balance the firm goals with aspirations of his or her staff?* 3. Does this person work in a highly organized and disciplined manner?* 4. Does this person communicate in a way that keeps others well informed?*		

(continued)

* Adapted from the Succession Institute Managerial Leadership Assessment.®

Step 4: Address Current Shareholder Deficiencies. What if your current shareholders do not possess these expected shareholder competencies? Then they need to be put on a development path and given a time frame to achieve them. Requiring a shareholder to grow is not the problem; the problem is allowing him or her to stagnate in this top position.

Issue	Assigned To	Date
a. Adapt all of the preceding steps to existing shareholders and set up a compensation system and other standard operating procedures to hold them accountable.		
b. Monitor shareholder performance and provide them with advice and assistance in making changes required in their behaviors.		
c. If a current shareholder refuses to go along with the new program, consider separating ways with him or her.		

(Adapted from Securing the Future: Building a Succession Plan for Your Firm, William Reeb, AICPA, 2005)

Appendix B

What You Can Start Doing Now to Develop Your People

Issue	Assigned To	Date
<p>1. <i>Give people throughout the organization the power and responsibility to do their jobs autonomously within established limits and boundaries.</i></p> <ul style="list-style-type: none"> • This doesn't mean that each functional area should set up its own rules and regulations; in fact, that is not recommended. • Instead, create a corporate structure that enables all staff and, particularly, potential leaders the chance to develop the kind of intuition and gut instinct, usually created through making mistakes and learning from them, that will serve them and the firm well in the future. 		
<p>2. <i>Chart your firm's skill sets.</i></p> <ul style="list-style-type: none"> • What kind of talent and experience does your staff possess? Do they reflect the firm's future needs? • Will they help achieve your strategic goals? • Are they being developed in line with your strategic goals? • In other words, do you have the proper staffing or hiring and promotion plans to support current and future client needs? 		
<p>3. <i>Identify managers or other staff with potential.</i></p> <ul style="list-style-type: none"> • Once you have staff members working independently and you understand what kind of talent you have, the firm should develop formal or informal processes for judging how well younger staff manage people and situations. • You also should consider providing training for the most promising candidates. 		
<p>4. <i>Understand the difference between a top-notch manager and a leader.</i></p> <ul style="list-style-type: none"> • Partner candidates should have not only strong technical skills but also entrepreneurial instincts and demonstrated leadership talent. • They should have unwavering ethics and be trusted by all around them. • They should constantly demonstrate the difference between doing what they want versus doing what they should. • Most of all, they should hold themselves accountable to the same standards, rules, and processes that they expect everyone else to follow. 		

(continued)

Issue	Assigned To	Date
<ul style="list-style-type: none"> • Leaders in accounting firms have to embrace the idea that although technical knowledge is important to delivering quality service, CPA practices live and breathe on the success of partners forming and maintaining close relationships with their clients and understanding their clients priorities, aspirations, and goals. 		
<p>5. <i>Mentor promising staff.</i></p> <ul style="list-style-type: none"> • Employees need good technical skills, but they also must understand what it means to handle clients and run a business if they are to take over the firm one day. • Give them responsibility, and if they run into problems, let them work through those problems (with occasional guidance, if necessary) so they can become stronger and more valuable employees. • Don't lock them up in the office. Introduce them to clients and the kinds of challenges that come up in the field. 		
<p>6. <i>Don't just talk about mentoring and client contact; get partners actively involved.</i></p> <ul style="list-style-type: none"> • This step is avoided at many firms because partners want to maintain client relationships without intrusions from outsiders. Although this might seem prudent in the short run, it is a bad long-term policy for the firm. The practice will stagnate if younger CPAs aren't introduced to existing clients and taught how to bring in new ones. • Although the firm should help younger firm members learn to handle client contact, it may turn out that some of them may not have a talent for building client relationships. If that's the case, we may need to rethink whether they are partner material, bring them in as technical partners (with clear limitations about what that means), or demote them to a nonequity owner status. • In the end, client service partners should always drive CPA firms, not technical partners. CPA firms are in the client service business, and it is difficult to build and sustain a successful practice unless you develop partners who can establish and maintain client relationships. Too many senior owners create an organization of technical partners to assist them in managing their books of business, which, after their retirement, handcuffs the few remaining entrepreneurial owners because the technical partners do not embrace some basic tenants of running a successful practice. • Clean up your ownership house now and start developing all your partners so that they are ready to take your firm to the next higher level, not the next lower one. 		
<p>7. <i>Include junior staff in decision making.</i></p> <ul style="list-style-type: none"> • Although key decisions must still be made by top leaders, consider how the firm can include younger staff in selected decisions and perhaps delegate some choices to them. • This not only offers them greater responsibility but also improves morale and aids in the retention of talented people. 		

Issue	Assigned To	Date
<p>8. <i>Set your firm's requirements, financial and otherwise, for new owners.</i></p> <ul style="list-style-type: none"> • What size book of client relationships should they be managing, at a minimum, to begin the ownership process? • What level of realization do they need to maintain? • What kind of staff leverage should they have in the work they do? • How much will they need to come up with for a capital account and under what terms? 		
<p>9. <i>Get formal leadership training for the appropriate firm members.</i></p> <ul style="list-style-type: none"> • This should complement but not replace day-to-day coaching and mentoring by senior leaders. A key here is to make sure that the senior leaders who are coaching the incoming leaders have formal training in this area. Many mentors try to teach their mentees to be exactly like them. • However, what firms should be striving for is to build better leaders, not just create a mirror of what exists today. Firms have to strive to be better, faster, and stronger, not worse, slower, and weaker. 		
<p>10. <i>Set up a timetable for new leadership.</i></p> <ul style="list-style-type: none"> • Will the new managing partner (MP), for example, take over when all the senior partners have retired, or will the reins be passed sooner than that? Many consultants recommend that a new MP be installed while older partners are still on the job. These partners should offer advice and support without trying to interfere with the new leader's authority. • The true test of leadership is whether the senior partners put in a system of governance that they adhered and held themselves accountable to during their later years. "Follow my lead" is a far more powerful motivator than "do as I say, not as I do." 		
<p>11. <i>Don't underestimate the amount of time it can take to groom a new partner.</i></p> <ul style="list-style-type: none"> • Some CPAs believe it can take as long as five years to nurture the requisite leadership abilities. In planning for a transition, the firm should allow enough time for the person to qualify for, and grow into, his or her new role. • Also, consider that some people chosen to be leaders will not make the grade. • Don't set up a system that defaults to people being named partners just because they were selected for a partner-in-training development slot. The test of a partner is whether he or she will embrace and adopt the roles and responsibilities of a partner, allow him or herself to be held accountable to the firm, have the personal integrity to be trusted, work to do what is best for the firm, and be willing to work within the governance systems and standard operating procedures in place. 		

(continued)

Issue	Assigned To	Date
<p>12. <i>Create a compensation plan.</i></p> <ul style="list-style-type: none"> • A clear-cut compensation system offers the kinds of incentives and rewards that help retain staff and motivate promising future leaders. • Compensation systems should be performance based but change with strategy. • They should include both objective and subjective elements. • Every person should have personal goals that are monitored and constantly updated to help that individual meet his or her objectives while supporting the firm's overall strategy. • Because compensation drives implementation and implementation drives attainment of the firm's objectives, it should be no surprise that established compensation levels and programs also support a successful succession plan. 		

(Adapted from The 2008 PCPS Succession Survey, AICPA Private Companies Practice Section)

Chapter 8



We Need to Formalize Transition, Roles, and Responsibilities of Our Retiring Partners

Introduction

Now, it's finally time to focus on those partners getting ready to retire. This chapter will discuss the transitioning of clients and developing policies to address the soon-to-be retirees. For example, we will cover mandatory sale of ownership age, noncompete agreements, retired partner compensation, roles that the retirees can fill, and so on.

A key issue we will delve into is transitioning clients. Why? Because all too often, partners retire still owning many of their key client relationships. This creates a problem with no good solution because the firm is acting too late and is in a poor position to invoke consequences. In our opinion, if the retiring partner has not properly transitioned his or her client relationships to the remaining partners, then the retiring partner should not be entitled to monthly retirement payments.

In addition, if the retiring partner publicly disparages the firm at any time during the retirement payoff period, all payments should stop until damages can be assessed or public retractions occur. It comes down to this: with professional service businesses, justification for the purchase of a revenue stream is the expectation of the continuation of that stream and its related profits. If the retired partner has not properly transitioned the relationships

or is undermining the marketing efforts of the firm through public disparagement, then the value assessed for a partner's interest will be overstated by the likely lost clients or damage to the firm's reputation, or both.

Another issue is the age that you are required to sell your ownership. Often, this is referred to as *mandatory retirement age*. However, the issue is less about retirement than about the forced sale of ownership to the younger partners. When a firm is running well and is profitable, why would a senior owner leave? Typically, he or she can work less, make one of the higher salaries in the firm, and basically retire in place, allowing him or her to covertly increase his or her retirement payout. Therefore, there comes a time in the evolution of every organization when the senior leaders need to step aside and let the next generation of leaders take over.

Given the shortage of staff, most firms want their retiring owners, who often also are their top technical talent, to continue contributing to the firm's production. However, retired owners need to be treated far differently than they were treated when they were active. Important policies need to be put in place to ensure that the firm benefits from the additional hours of this talented group rather than being exploited by them.

If this historically entitled ex-partner group is going to continue to work for you, the next question is, "What is a fair way to compensate them?" The key is to set up a compensation policy that is fair to both the existing partners and the retired ones. The fact is that many firms want and need this talent to stick around, but another fact is that oftentimes, the deals that are struck are mostly good for the retired partners and not so good for the remaining ones.

These are just a few of the ideas we will cover in this chapter, which was created to help you put together a framework to leverage the talents of retired partners who still want to contribute but to do it in a way that creates a positive and profitable outcome for everyone. We will also cover how to allow them to retire or gracefully phase out of the practice. Now it is time to talk about how to position your firm so that it can fairly manage and treat those people who have given years of their lives to build your successful firm.

Our premise has always been the same throughout this book and its companion volume. Succession to the next generation of leaders, dealing with the retirement of an owner, or the transition of a member of leadership from owner to employee is all fairly easy and straightforward if you run your business well with formal processes, procedures, accountability, and governance. So, for a quick recap, to be ready for the successful exit of an owner at this time, your firm should be

- developing a strategic plan and operating according to the plan.
- operating using a more corporate form of governance with clear roles, responsibilities, powers, and limitations for the board, managing partner or CEO, individual partners, committees of the board, task forces and committees of the managing partner, and so on.
- following a standard operating procedures (SOPs) model and holding everyone accountable to those SOPs.
- developing a succession plan that identifies possible successors for every key role in the firm and that goes far beyond just partners' positions.

- developing leaders throughout the organization (in other words, putting people in leadership positions and allowing them to grow by giving them responsibilities and the appropriate authority).

For more on any of these topics, please review chapters 1–3 and 7 of the materials in this text or take a look at our primer, *Securing the Future: Succession Planning Basics*.

Now, let's move on to the focus of this chapter. Some of the issues that quickly come to mind that your firm will need to discuss and decide upon are the following:

- Partner awareness of natural retirement anxiety
- Mandatory retirement or mandatory sale of ownership
- Transitioning of clients
- Potential roles and compensation of retired partners
- Personal liability of remaining owners for retired owners' full payout
- Ability of the retired partners to block merger or sale of business or line of business
- Insurance coverage of the outstanding retirement obligations
- Partially funded retirement plans
- Acts that can trigger a reduction or discontinuation of benefits
- Acts that can trigger a change of ownership

It is interesting to note the issues most commonly addressed in firms' retirement agreements and policies, based on responses to *The 2008 PCPS Succession Survey*¹ we recently conducted. As the following table shows, responses from the 2008 survey generally were similar to those of the 2004 survey.

Partner Issues Addressed in Firm's Agreement or Policies	2008	2004
Mandatory retirement age	48%	41%
Allowable activity with clients after retirement to ensure retention	32%	49%
Acceptable arrangements or situations allowing retired owner(s) to continue working for the firm	46%	57%
Personal liability of remaining owner(s) for the full payout to retired owner(s)	27%	28%
Specific recourse or cures should the retired owner(s) not be paid in full	20%	19%
Ability of retired owner(s) to block mergers or total sale of the business unless retirement obligation is paid in full prior to the transaction	11%	9%
Ability of retired owner(s) to block the sale of a line of business unless the retirement obligation is paid in full prior to the transaction	6%	3%
Ability of existing partner(s) to change the retirement benefit of retiring partner(s) due to improper client transition	18%	N/A
Key person insurance to cover outstanding retirement payment obligations	54%	51%
Acts that can trigger the forced retirement of the owner(s) (illegal activities)	62%	63%

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¹ AICPA. *2008 PCPS Succession Survey*. The Succession Institute, 2008.

Partner Issues Addressed in Firm's Agreement or Policies	2008	2004
Acts that can trigger the forced retirement of the owner(s) (misconduct, such as sexual harassment, public embarrassment of the firm, and so on)	57%	54%
Acts that can trigger the forced retirement of the owner(s) (lack of performance)	31%	34%
Acts that can trigger the forced retirement of the owner(s) (owner disability)	52%	60%
Other	5%	9%

N/A = Not asked in that year's survey.

We will address these issues in more detail subsequently.

Partner Awareness of Natural Retirement Anxiety

Before we discuss the suggested approaches to retirement processes, issues, and transition, it is important for all the partners to recognize that your retiring partners often have spent the better part of their lives devoted to this firm. Even if they are ready to go and want to pursue other personal interests, most of them have a strong need to feel supported and appreciated by the existing owners. Recently, we went through a negotiation of a buyout with a majority owner partner, and although he was happy with the final numbers and arrangements, as were the existing partners, in the end, the comment made to us by the retiring partner was, "It is sad that this became just a business transaction because what puts a negative taste in my mouth is the fact that I don't feel like my partners appreciate what I have done for the firm or thanked me for my years of service to this business." However, in the eyes of the existing partners, they clearly felt like they expressed that sentiment by the retirement benefits to which they agreed.

Now, consider the scenario in which the retiring partner is not really excited about moving on and is not sure how he or she is going to fill a life that heretofore was spent at the office. This level of anxiety makes this whole process even more frustrating and a borderline "powder keg" situation. Although we have spent a good portion of this book beating up the founding fathers and senior owners for the typical responses and reactions we encounter, keep in mind that without them, the existing owners wouldn't even be having a buy-out conversation because there wouldn't be anything to buy.

We have to keep in mind throughout this process that major changes in our lives, such as retirement, are personal, emotional, and difficult even when we want them and significantly more so if we are on the fence about them. Although it is your duty to do what is right for the firm and protect its continuing partners and employees, we always need to remember to be compassionate, grateful, humble, and respectful to those who have led us to our current destination.

Mandatory Retirement or Mandatory Sale of Ownership

Mandatory retirement age is becoming a big issue with many firms because the founding fathers and many senior owners want to extend their careers beyond an agreed-to retirement date.

First of all, let's distinguish between mandatory retirement and mandatory sale of ownership. We believe that partners should be allowed to work until the partner group does not feel they are adding value to the organization. The key distinction here is that this decision is the firm's to make, not the past or retiring owner's. Thus, when the firm decides that a past owner is no longer pulling his or her weight or if this person will not follow the rules or causes problems with existing partners or staff, a simple, clear, clean, quick, and definitive process for letting him or her go must be in place. With this approach, partners could sell their ownership and continue to work for the firm in either full- or part-time roles well into their 70s (maybe 80s, for some) and continue to have a productive and viable career. So, be clear about what you are requiring at some mandatory age. We recommend that you require owners to sell their ownership interests at some set date.

There should be a prescribed date for the mandatory sale of ownership. More and more, we are seeing mandatory dates set according to when the owner is eligible for full Social Security and Medicare benefits (for most people, that's presently 66 or 67 years of age). The reasons for this requirement are twofold. First, if you are trying to attract young people into ownership, they need to feel sure that the torch for running the firm will be passed to them at some specific point in the future. We have found that when no mandatory sale of ownership age exists, many CPAs will work into their mid-70s, maintaining effective control of the firms while doing so. Second, tying the sale of ownership to this date allows retiring owners, under current law, to work without reduction of their benefits and sign up for affordable Medicare health insurance benefits, as well.

Recently, we conducted a firm retreat with a group of partners who ranged from 40 to 63 years of age. We went around the room and asked everyone when they planned to retire. The earliest response was within 5 years, with the latest retirement date being 15 years out. With 10 partners, the average term to retirement was 9 years, with the median being 10 years. This was a shock to the partner group as a whole because they expected the youngest partners to plan on working at least another 25 years, maybe more. Instead, the partners furthest away from retirement didn't plan to work that much longer than the one closest to retirement. This is just one example of many instances we find in which our younger people don't see themselves working as long as many of our founding fathers plan to work. If younger partners or firm members expect a founding father or two to hang around for an indefinite period after typical retirement age, it will make it more difficult to attract and retain younger people who wish to become partners or to keep existing junior partners from splitting off. Why? It is simple: the younger people don't foresee a time when it will be their turn to hold power positions within the firm. Although we are the first to admit that

financial reality likely will not let these younger people retire at such an early age, the issue isn't one of reality but one of perspective.

A couple of other issues occur when key leadership roles are occupied by people in their 70s and early 80s (although we find these to be typical, numerous exceptions exist, of course). The first is that, as we get older, we tend to become more risk averse, less enamored with new technology, and not as willing to make further investments in the firm. In other words, when we start thinking that we might stop working, we become less inclined to spend a lot of money or incur debt for benefits that will be reaped from three to five years beyond our time to enjoy them. This perspective can easily cause a firm to stagnate and hamper its ability to invest in the necessary infrastructure to ensure a successful future.

Another common scenario we run into is that the older we get, the harder it is to connect with the perspectives of our youngest employees. Often, we still cling to behaviors, attitudes, and other attributes that were common during our upbringing, and we increasingly struggle with those of each generation to follow. When there is a 50-year gap between an owner and staff, the firm's appeal can be lessened by a preponderance of ideas and ideals that make it more difficult to attract and retain quality employees.

As we get older, abrupt-onset health issues are not only more prevalent but, often, far more devastating. When you consider that partners are not only the key client-service people but also fill the firm's management positions, this can be crippling to firms if they have not planned well for this kind of chaos and catastrophe. In our experience, the likelihood of this kind of catastrophe grows significantly higher with each year a partner ages beyond his or her late 60s.

Finally, the most sensitive issue is quality control. When does a partner's skill level and personal clarity deteriorate to the point of being a problem? We have worked with firms that have a senior partner who refuses to retire, so the junior partners have to quietly redo his or her work behind the scenes to fix the poor work product. Although this might show great respect for the senior partner, it is not fair to the firm to operate in such a manner.

These are all examples of why firms should have a mandatory date in place for the sale of ownership interests—a date that is enforced without exception. Past partners, at the option of the firm, can continue to work under terms we'll talk about subsequently.

Once a partner transitions to retired partner employee (RPE) status, the concerns previously detailed can be much more easily mitigated. For example, RPEs should not have much, if any, client account management as part of their job duties. By the time a partner becomes an RPE, he or she should have transitioned all of his or her clients to the remaining partners. If a health issue arises, because the RPE is no longer in a key management role or responsible for a large group of clients, the health issue may be devastating because of the personal relationships between the partners, but it will have less effect on day-to-day operations. Similarly, when the RPE's work is no longer up to standard in a specific area, it will be far easier for the management group to reassign job duties that are in line with the skill and contribution level of the RPE. Also, when the RPE is no longer part of the management group, he or she will not be influencing the firm's investment decisions, policies, and processes. Finally, because the partner will have converted to RPE status on schedule, younger members of the firm will see more opportunity at the top.

We recommend that partners be required to convert to RPE status or retire when they are eligible for full Social Security benefits. However, this is a generalized recommendation, and each firm's owners have to make the right decision for their organization. Just remember that you are better off making decisions like this from a "continuation" versus "success" mode perspective (see chapter 7 for more details on these two modes).

Finally, part of your policy on this issue needs to address communication to the clients. When a partner is retiring, we believe a formal announcement should be made to the clients. This is an opportunity to publicly wish this partner well and let it be known that, although the retiring partner's shoes will be tough to fill, the firm is excited about the opportunity to continue to build upon the foundation of ethics, quality service, and client care that the retired partner has demonstrated. If the partner is selling his or her ownership and converting to RPE status, it is still important to make such an announcement. You might convey that the firm is excited that the retiring partner is moving to a semiretirement status and that the firm is proud of the contributions he or she has made to the success of the firm. Emphasize the point that, although it is comforting for everyone to know that the RPE is still around and available, because he or she is cutting back his or her availability, every client will have a key full-time person assigned to be his or her contact and take care of him or her. Finally, make it known that the firm, with all its partners and staff, stand ready to try to fill the gap created by such a talented RPE taking more time to pursue other lifelong personal interests.

FYI, the RPE will not want you to announce his or her retirement or slow-down because he or she won't want the general marketplace to think of him or her as phasing out. However, this is an important step in the transition process. It is hard for clients to see a reason to accept a change in their client service partner if they don't believe anything is changing regarding their existing client service partner. Like we said, making this a formal part of the sale of ownership and retirement policy will take the sting out of this issue because everyone will know exactly what to expect. When partners are 10 years from retirement, this kind of client communication seems like a no-brainer decision to make and process to approve. However, once this becomes personal about someone's specific retirement, partners often change their minds, trying to keep all of their options open. So, our advice is to approve this communication process now and make it part of your known retirement SOPs.

Transitioning of Clients

The following nine-step approach to transitioning clients to ensure continued loyalty and retention is very simple and straightforward. We can hear you ask, "If this is so easy, why do so few firms do it well?" Client relationship transitions are handled poorly in most firms because no system is in place to force the senior owners to do them well. We are going to address how you might want to approach this; however, other extenuating factors exist, such as the following:

- The partner compensation system motivates the retiring partners to crank out billings in their final years (both to maximize their annual net pay to pad their retirement nest egg and, often, to drive up their retirement benefit calculation). Typically, with most firms, this means ramping up your personal billings and keeping all your client relationships as long as you can.
- Not transitioning clients gives the retiring owner about to become an RPE more leverage. Any failure in transitioning client relationships to a remaining partner prior to the sale of ownership will convert into a postretirement work opportunity. Often, RPEs transition a portion of the clients they serve, sell their ownership, and then continue to work on their best clients after retirement. This gives the RPE an excellent opportunity to demand special compensation (or he or she won't come back to transition those "best" clients) or a client base to whom they are responsible, which creates excellent additional revenue generating opportunities long after retirement.

The point is that it is usually in the best financial interest of the partner who is about to sell his or her ownership to hold on to clients rather than transition them. As we have said so often, never be surprised when people do what they are being paid to do. So, in order to raise the priority of properly transitioning clients, you have to take the reward out of not doing it.

Here are nine steps we recommend you follow for successful client transition:

1. The managing partner or CEO should be in charge of developing the transition plan. This is not a job for the board unless it needs to provide some high-level guidance to the client redistribution process as a whole.
2. The retiring owner's current compensation and future retirement benefit should be conditioned on following the plan, with emphasis directed away from billable hours and toward transition, business development, community visibility, training his or her replacement, and mentoring. Sizable penalties to the retirement benefit should be imposed for lack of compliance with the plan.
3. A minimum of two years, preferably three, should be allowed for this process. The bigger the size of the book and the more extensive and complex the client work, the more appropriate the three-year time frame.
4. A list of clients who need to be transitioned should be created.
5. People taking over account responsibility should be identified for each account.
6. A calendar should be created that depicts the order and timing of initial contacts for each client.
7. The largest and most important firm clients should be transitioned first. The larger clients will take more time to transition because of the amount of work being performed, so this gives the retiring owner time to gently phase out.
8. Some firms create a team approach to serving their largest clients so when people are moved in or out of the account it seems to be less about transition and more about better client service.
9. SOPs should be established that outline the allowable follow-up and involvement from retiring owners once transition begins. As an example, a firm might set up a process such as the following:

- a. In the first year of transition, any time service reporting or follow-up occurs with a transitioning client, the retiring owner will not conduct those discussions without the newly assigned account manager present.
- b. In the second year, the retiring owner might defer the presentation of all services to the new client service partner or manager.
- c. In the third year, the retiring owner will find excuses to not be present at most of the client meetings. In addition, that owner will issue constant reminders to his or her friend and client that the new client service partner or manager is the one who knows what is going on and has been taking care of him or her.

The simplest way to describe the phase-out process is that the retiring owner has to become systematically incompetent. This is very hard for people who pride themselves in their technical prowess. Here's how it works: throughout the transition period, the retiring owner

- needs to understand that he or she should constantly be selling the competence of the person replacing him or her.
- should be, with each passing month, less and less involved in the management or oversight of the client work and should be purposely portraying to the client that he or she is unaware of the project status or outstanding issues.
- stops answering business-related questions during nonbusiness hours or personal activities with the client. (If this does occur, the retiring owner will undermine the person taking over the account.) The retiring owner needs to reply with, "Let me get back to you. I want to run this by Sue because she is more up to date on your situation. One of us will get back to you tomorrow morning." This shows that the retiring owner still cares but that the current client service manager is thought of as an essential resource to providing quality service.

It's very important that these steps are followed consistently and continually, or all your hard work will be for naught. For example, a client transition could be going very smoothly and then, one year into the process, the client calls the owner at home for help, and he or she instantly responds with a solution instead of referring the client to the new contact at the firm. In that moment, the retiring owner will have undermined one year's worth of effort by making it clear to the client that he or she is still the go-to person.

This is the whole point of systematic incompetence: in a three-year transition (counting down to the retiring owner's departure date), the retiring owner's focus in year three should be on making sure the incoming client service partner or manager is always brought into the full client conversation, both business and personal. In year two, the retiring owner should be publicly deferring to the client service partner or manager and no longer answering questions without involving the client service partner or manager. By year one, the retiring owner's conversations should be solely personal, and he or she should avoid business issues altogether. If trapped by a client who insists on seeking advice or information from the retiring owner, the retiring owner should sell the skills of the client service partner or manager while admitting that he or she doesn't want to answer because he or she has not been staying current.

In chapter 7 we discussed balancing book size among partners. Part of the reason we like this approach is because it allows a shuffling of clients so that by the time a partner is ready to retire, he or she is not doing so with a book twice as big as everyone else's (which only makes the transition process more difficult to manage). Having a bigger-than-average book size in a partner's final years as an owner only provides him or her with more leverage for negotiating a special deal for retirement or for staying on after retirement. Founding fathers usually want special privileges to transition their books, anyway. Most of them won't want to transition completely because they want to keep a good-sized client base to force the remaining partners to pay them after retirement to stay around and maintain those accounts or to slowly transition the rest over to other partners. They have all kinds of reasons why they don't transfer the clients, from "that partner will just run off my client" to "the partner doesn't have the skill to do the work."

As you can guess, the continuation mode is all about stopping this from happening. First, you have SOPs that don't allow partners to keep books after they have retired, and if they do, their payout is reduced. Second, if the statement that a partner "will drive away the clients if transitioned to them" is true, then this mode puts the emphasis on transitioning early. Why? If partners can't retain client relationships transitioned to them (we are not referring to a one-off situation but, rather, multiple situations), then why are they partners? Why would we want key partners who are retiring to leave several weak partners for the remaining partners to carry on their backs?

The continuation mode delivers a consistent message: deal with it now. What we tend to find is that the partner who will presumably run off every client they get is much better than everyone thought they'd be, and they do just fine. They might treat the clients differently, but in many cases, that is not a bad thing. In the rare instance that a partner can't keep clients but you decide to retain him or her as a partner, you need to know this early on so you can minimize this person's ability to sabotage the next generation of leaders (see the ownership rights discussion in chapter 7).

Process for Improper Client Transition

Firms should have a process for dealing with retiring partners who don't, won't, or can't properly transition client relationships. Although fewer than one in five firms has a provision like this, we highly recommend it. This is simply about economics. To the extent that the retiring partner has properly transitioned the client relationships, the clients will most likely stay with the firm. In turn, this will provide the annual cash flow to pay off the retired partner, pay the new client service partner or manager, and provide profits for the firm. If the firm loses clients due to sloppy, inadequate, or nonexistent client handoffs, then the retired partner is being paid for value the firm did not receive. As we said earlier, the key is to take the reward away from the retiring partner for not transitioning his or her clients and augment this process with a penalty instead. Keep in mind that in an outright sale or merger, you can bet the acquisition or merger firm will have built harsh penalties into the deal for nonexistent or inadequate client handoffs, so we are not referring to anything the marketplace isn't already demanding.

In our view, if the retiring partner has not properly transitioned his or her client relationships to the remaining partners, then the retiring partner should not be entitled to monthly retirement payments. Unfortunately, with many CPA firms, senior partners often take advantage of the remaining partners on their way out with the juicy rationalization of “this firm would not exist without me so I am entitled.” Our comment is that most of the time, the senior partner and founding fathers are paid market value for their share of the firm but want even more on top of it. This is typically accomplished through a number of side agreements. Common ones include the firm

- being required to pay the retiring partner to stay on and manage client relationships that should have been transitioned but were not.
- having to pay more than market value for the services of the retired partner. Instead of being paid within a range of \$0.25–\$0.33 on the dollar for the revenue collected from the RPE’s work, the RPE makes 40 percent, 50 percent, or more on his or her personal billings.
- having little say about the continued employment or terms of the retired partner. Instead of the firm determining whether, how, or how long the retiring partner is allowed to perform work for the firm, the retiring partner sets the terms and conditions of that relationship as part of the exit package (in other words, the firm cannot really fire the RPE).
- providing perks, such as secretarial support, office space, phone, equipment, health coverage, insurance, club dues, and so on, all of which are not tied to future work performance but to entitlement.

All of this comes down to one issue: poor business management practices. Regardless of how much ownership the senior partner has in an organization, the remaining partners have significant control about how their futures unfold. The most common threat is that the senior partners will sell the firm or, worse, stay on indefinitely if the remaining partners don’t acquiesce. The reality is that few firms want the clients without the associated talent—the remaining partners. That means that if the remaining partners are hostile to any deal, few firms will be willing to finalize any purchase or merger because of the ugly complications this situation creates. Also, if the younger partners band together and threaten to secede from the union, this will usually generate a wake-up call to any retiring partners. Not only will either of these alternatives be far worse for the retiring partner from an economic standpoint, even more importantly, the senior partner is not going to be interested at this stage of his or her life in putting in the effort required to rebuild a fragmented firm.

We’re not trying to create rifts within firms by covering this. We mention it because everyone in every firm has a really good reason to sit down and work out an equitable solution. That solution needs to be put together from the perspective of the continuation mode. What choices can we make that pay people for the asset they have been involved in growing while ensuring that the firm continues to be strong and prosperous?

So, now we cycle back to client transition again. As we previously defined it, this process is fairly simple. However, here is the incentive issue that we have yet to cover, with our solution: as long as the retiring partner adheres to the requirements of the transition plan

with no clients identified as being improperly transitioned, regardless of whether his or her clients stay with or leave the firm, the retiring partner shall receive the full amount of the retirement benefit to which he or she is entitled.

Why? Because if the retiring partner did the job he or she was asked to do in order to transition the client relationship, it is not the retiring partner's fault if the firm later loses the client. In this case, the new partner had time to build a relationship but failed to do so (by the way, if this happens often, the problem with the remaining partner needs to be addressed right away).

At each six-month period of the three-year transition plan, the managing partner is responsible for informing the retiring partner about whether he or she has followed the plan and which client accounts are at risk due to improper transition. By the date of retirement, should the retiring partner not have adhered to the transition plan or should specific clients be identified as being improperly transitioned, then a deduction from the retiring partner's retirement benefit will be calculated in the following manner for all improperly transitioned clients who leave the firm:

- For improperly transitioned clients lost during a 24-month period after the retiring partner's retirement, the previous 2 calendar years' fees collected (starting with the year of retirement) for each client lost will be calculated and averaged.
- The average annual fees for each client lost due to improper transition will be deducted from the partner's retirement benefit. This reduction will first be assessed against the deferred payment portion of the retirement benefit, and once that is gone, it will be assessed against the partner's capital account amount.
- The remaining retirement benefit will be recalculated based on the remaining term of the payout period to redetermine the monthly retirement benefit payment.

Should the retiring partner be the managing partner, then the managing partner needs to step down at least three years prior to retirement so that a new managing partner can manage the transition process for the existing managing partner, as well as have time to be mentored, if desirable, by the outgoing managing partner.

We have included appendix A, "A Sample Partner Transition Plan," to start you thinking through the process of customizing a partner transition plan for your firm. The section that you will customize the most will be the planned action or activity section. This is where you are to insert instructions such as the following:

- Introduce the client to Sue (the new service partner) and tell the client you will be working together on their account this year as part of the firm's succession plan.
To be completed by 1/18/11.
- Schedule a client meeting to review the status of his or her financials and make sure Sue plays a role in the discussion.
To be completed by 7/15/11.
- Schedule a year-end planning meeting. Have Sue lead the meeting, with limited participation from you.
To be completed by 12/15/11.

- Tax return preparation meeting. This should be scheduled by Sue. Do not attend the meeting, but pop your head in during the visit to assure the client that he or she is in great hands.

To be completed by 3/15/12.

- Posttax season 2012, this should be Sue's account to manage. Should a client call you after tax season 2012, you will defer to Sue for all questions. Although you can maintain your personal relationship and contact, if you answer any technical questions after this period, you will be undermining the transition. When asked for your advice, defer to Sue. Let the client know that you will have Sue return the call, and emphasize that Sue is best positioned to answer the question.

Post-2012 tax season.

This is just an example of the kind of notes that will be found in this section. You can elaborate as much or as little as you want. Each quarter, if the task assigned is performed, the retiring partner will have fulfilled his or her end of the bargain, and this should be appropriately noted in the sign-off section below the client's name.

Potential Roles of Retired Partners

Once an owner retires, what types of involvement does he or she have with the firm? We asked that question in *The 2008 PCPS Succession Survey*. In more than one-third (36 percent) of the firms, retired partners have no involvement with the firm. Nearly one-quarter (23 percent) of the firms allow retired owners to work on some of their old clients but in the role of a manager because another partner handles the client relationships. About one in six firms still allow retired partners to manage client relationships.

Retired Owner(s) Involvement in the Firm	
The retired owner(s) has no involvement and influence in firm operations.	36%
The retired owner(s) still works on some of his or her old clients but more as a manager because another partner handles the relationship.	23%
The retired owner(s) does what he or she has always done but just works less hours.	17%
The retired owner(s) continues to manage client relationships.	16%
The retired owner(s) is still active in the community and has a formal role of being an ambassador for our firm.	16%
The retired owner(s) is on an annual contract with the firm, with specific allowable activities he or she can perform.	10%
The retired owner(s) is invited to board or management meetings but does not have a vote.	7%
The retired owner(s) still does pretty much what he or she has always done.	4%
The retired owner(s) still works at the firm out of respect, but we always double check his or her work before it goes out.	4%
The retired owner(s) is invited to board or management meetings, and although he or she does not have a vote, he or she is still very influential.	3%
The retired owner(s) is commonly invited to board or management meetings and still votes.	2%
No current retired owner(s).	34%

In our opinion, once a partner transitions to RPE status, the RPE should be acting more as a manager or firm ambassador than as a partner (depending on the needs of the firm). With the successful transition of client relationships, others have taken on the role of point person on the clients formerly handled by the RPE. This means that the RPE can fulfill a role as a technical reviewer or preparer within the firm. He or she can act within the firm's market area as a goodwill ambassador, keeping the name of the firm out in the community, making contacts, and referring business to the firm. Another great role is that of technical trainer. Rarely do partners and managers have enough time to put on consistent, quality, and thorough technical training for higher-level employees (from seniors and supervisors to managers and junior partners) within the firm, but the RPE absolutely can spend time doing this. Improving the quality of processes within the firm is a good area to consider, as well, if the RPE is both qualified for this work and interested in performing it.

Given that the real job of management is to develop people and build a stronger firm, although the RPE can have a definite role in training and process improvement, the RPE should probably avoid direct personnel management and supervisory responsibilities, except when acting as a project manager. It is best to leave the personnel development up to the people who will have to live with the end products of their supervisory efforts.

Sometimes we hear of firms that wish to have a retired owner take on some firm administration. This can be good and bad. On the positive side, a retiring owner who's been involved in the firm management or administration could probably step in and perform this work quite ably if a need is going unfulfilled. On the negative side, though, how much are the administrative tasks worth in the marketplace, and is the RPE going to be able to accept what likely will be a lower rate of pay and status for this kind of work? Also, it may sound simple to keep the firm administration function separate from general management, but how do you really keep the RPE out of this influential area or avoid the appearance to the rest of the owners that the RPE is still driving management decisions? Although we don't recommend this, it can be done, but it is tricky, it needs to be well thought out, and it takes a specific personality match to pull it off.

Remember that the reason for mandatory sales of ownership is to allow the next generation of owners to run the business. For that reason, RPEs probably should not even attend board or management meetings. We've seen some senior partners with personalities so intense that they influenced meetings or stifled conversation even when they didn't have the right to vote or have a say in the final decision. Utilize the skills of the RPEs, but let the current owners run the firm.

We recommend that RPEs be covered under annual employment contracts that need to be renewed by the firm each year to keep the arrangement in place. The contract doesn't need to be anything particularly complex, but it should briefly lay out what your expectations are for the RPE, as well as limitations on what the RPE's duties involve. We recommend that RPEs get paid somewhere between 25 percent and 40 percent (we like 33 percent) of what the firm collects from their billings. That needs to be spelled out in the agreement, too.

Without a required annual renewal of the RPE contract, bad things often happen. Anyone asked to stay around and work after the sale of ownership usually has a very loyal following within the firm or has strong-armed his or her deal. In either case, it isn't uncommon to see a love-hate relationship with the RPE: the remaining partners really respect what the RPE was able to accomplish while an owner and admire him or her for his or her abilities, but the remaining partners also want the RPE to step into the background so they (the current owners) can spread their wings and take the firm in whatever direction they desire without conflict or criticism from the RPE. From our perspective, because of this love-hate relationship and the current owners not wanting confrontation and dissension from members of the old guard, an annual contract is a required component of this process.

Often, a great deal of baggage exists between the current owners and the RPE; therefore, firms have to define a process to mitigate possible conflict and confrontation. So, the deal with an RPE should be the following: "If we (the firm) don't actively renew your (RPE) annual contract by the 11th month, then your contract will not be extended, and you should start working on tying up loose ends and packing up your office." Without this clear contract, an RPE might be asked to work an extra year with the intent of that being the only year, and many more years will pass before the partners get so furious that they have an ugly confrontation with the RPE and fire him or her. This shouldn't have to happen. Letting an RPE go shouldn't cause partner conflict. Although the RPE might be disappointed if his or her contract isn't renewed, setting up the kind of simple system and communication we recommend will be far less ugly than what usually happens when RPEs are forced out. Remember, it is always far easier, albeit a little more confrontational, to outline a process from the outset rather than trying to clarify everyone's positions after the fact.

On a positive note, when you have this type of arrangement between the firm and the RPE, if the RPE wants to continue to work, he or she usually will work much harder to make sure he or she is doing what the firm wants him or her to do. Without this type of arrangement, the RPE is likely to do exactly what he or she did when he or she was an owner until the situation blows up. For example, in a recent situation we observed, a partner was hired to stay on and be paid an hourly rate to do specific work. This in itself was not the problem. The current partners had the expectation that the RPE would get approval for the work he was doing. However, the RPE just did the work he wanted to do, including sitting in on meetings and attending firm functions, and billed the firm for every hour he spent. This went on far longer than it should have (which is common because of the baggage we previously discussed) until the situation came to an ugly head. Set this process up right and follow it to the letter with every RPE, and you will escape a great deal of drama and trauma that is absolutely unnecessary and avoidable.

Compensation of Retired Partners

The following summary is taken from *The 2008 PCPS Succession Survey*.

Retired Partner's Compensation Plan	2008	2004
Has been made available to every retired partner	21%	N/A
Has been made available to only a few retired partners	3%	N/A
Will pay the retired owner(s) to bring in new business	14%	20%
Will pay the retired owner(s) a salary to continue working for the firm	24%	26%
Will pay the retired owner(s) a percentage of his or her billings or collections for client work	23%	28%
Will pay the retired owner(s) to remain active in the community, serve on boards of directors, be involved in charity events, and so on	5%	6%
Will pay the retired owner(s) for the book of clients he or she manages	4%	N/A
Is the same for the retired partner(s) as it is for the active partner(s)	2%	N/A
Does not address these issues	41%	34%
Other	15%	11%

N/A = Not asked in that year's survey.

What we find in our work with CPA firms is that, typically, three common elements of compensation exist for retired partners who continue to work at the firm:

1. *Percentage of collections from their technical work.* This element compensates them for working in the role of a technical manager. We normally suggest a range of 25 percent to 40 percent of collections, but we recommend 33 percent. We've seen this component run as high as 65 percent of collections, but we think that 40 percent is pushing any defensible position other than the retiring partner taking advantage of the firm (unless the firm is trying to take advantage of the retiring partner with a submarket benefit package). To be clear here, these payments are based solely on the retiring partners' individual production because they no longer manage clients.
2. *Percentage of revenues for new clients or from new services to existing clients.* We see firms paying from 10 percent to 20 percent of the first year's billings to the retired partners for work they bring in to the firm. We have seen some firms pay up to 20 percent of the first two years' billings and others that pay a smaller percentage for the life of the relationship, both of which we think is excessive, but every firm needs to make that decision for themselves. We believe that these "commissions" for sales should not extend beyond two years and that, actually, some percentage of one year's fees should be adequate.
3. *Hourly pay for specific performance.* The firm may stipulate some activities with a retired partner, which the firm pays based on time expended. Such activities might include networking, serving on nonprofit boards, and so on. Often, the firm agrees to some annual amount based on approximate hours to be expended for an activity.

In addition to these three primary pay elements, firms typically provide additional perks for retired partners. This certainly would include providing retired partners with appropriate

continuing professional education. Paying for annual licensing and dues costs is a no-brainer perk, as well. Some retired partners are provided an office at the firm after they retire. We recommend that their new office be a manager-level office, and that their old office be given to a current partner or an up-and-coming leader. Any of these elements of pay, from the primary to the perks, should all be part of the annually renewable contract we discussed earlier.

As a point of clarification, don't try to sync up all the various compensation schedules within your firm. For example, although retired and existing partners both can have similar focus areas, it is not necessary to reward the two groups in exactly the same way. Compensation systems need to be built around the roles and responsibilities of each group (active partners, retired partners, RPEs, managers or staff, and so on). When you burden the incentive process with the requirement for the various schedules to be similar, you likely make the whole process weaker and less valuable. Every group is not the same, every group has different strengths and opportunities to leverage, and every group likely will have at least a slightly different focus based on their status within the firm. For example, it is less important to reward managers and staff for bringing in new business than it is to reward them for being active in the community and taking steps to build their network. It may be a requirement for all active partners to grow their books a certain percentage before any additional compensation is earned (because it is part of their role). From the first dollar of new business, you probably would want to reward any retired partners who are making efforts to find new opportunities. It is not about the retired partners closing the business but, rather, them opening new doors for the firm to explore. Then it becomes the job of the active partners to convert those opportunities into new business.

Personal Liability of Remaining Owners for Retired Owners' Full Payout

Only about one-fourth of the respondents to *The 2008 PCPS Succession Survey* indicated that their agreements held remaining owners personally liable for retired owners' full payout. You may ask, "Why wouldn't any owners be willing to step up to the plate and guarantee the payments for the retiring owners?" If you think about this in the context of a one firm business model operating in the continuation mode, we would put this another way: why should they? The senior owners often brought the junior owners into the business, set up the system of governance, and have been influential in crafting every aspect of the firm's operational structure, from training and development to client mix and offered services. So, the partners taking over are working within the limitations or opportunities created by the retiring partners. If the retiring partners have done a good job, the partners will have no trouble staying together, with the firm providing plenty of profit to pay off the debts of the firm. However, if the firm is held together by chewing gum and duct tape because of years of deferred maintenance by the senior partners, then saddling the junior partners with guarantees of the retiring partners' retirement benefit seems unfair.

Some reading this would respond, “If we sell the firm to someone else, we would demand that they personally guarantee the obligation, so why should it be any different for our existing partners?” Although we will cover purchase issues in the next chapter, suffice it to say for now that many firms are bought without personal guarantees (it is more complicated than that), and even in those deals that include guarantees, the buyer already has his or her own infrastructure and processes, so he or she is just buying client lists and people. Corporations with retirement plans don’t guarantee those benefits, and we see the junior partners buying out the senior partners being more analogous to this type of payment. We recommend a guarantee by the firm, not by individual partners. The retired owners will have some recourse if they don’t get paid, which is discussed subsequently.

Specific Recourse or Cures Should a Retired Owner Not Be Paid in Full

On the face of it, you may believe that if you’re asking a retired owner to work hard to assure a complete and effective transition of client relationships, with a penalty for not properly transitioning clients, it’s only fair to provide the retired owner with some recourse or cure if he or she doesn’t get paid in full. Typically, what we see is that upon default in retirement payments, the retired owner will get his or her ownership interest back and will then sit in on owners’ meetings and participate in owner group or board of director decisions. As you might imagine, a retired owner in this position will likely try to influence and micromanage the firm’s business decisions, especially the strategic ones, so the current owners most likely will find it in their rational self interest to keep up with scheduled payments.

Ability of the Retired Owners to Block Mergers or Total Sale of the Business Unless the Retirement Obligation is Paid in Full Prior to the Transaction

Some retiring owners will insist on a provision that allows them to block the merger or sale of the practice unless their obligation is paid in full prior to the merger or sale. The previously referenced survey shows that approximately 10 percent of the firms have this provision in their agreements. It’s understandable that a retired partner would be concerned that his or her buyout could evaporate in a sale or merger conducted in the future. You might be thinking, “For a retired partner to be able to block a sale or merger for a total cash-out on the front end seems unreasonable. Most sales or mergers have little, if any, front-end cash payments to the sellers involved from which to pay the retired partners in the first place. In fact, a merger or sale could actually strengthen the retired partner’s position.” We agree on the last statement; in many cases, particularly in upstream mergers, a merger could actually be better for the retired owners. However, consider a situation in which in the current owners are merging to gain certain instant personal advantages. They are basically able to make such a lucrative deal on the backs of their retired partners. Why should the people financing part

of the deal (those who built the firm and are being paid off for the value they created over time) have to live with whatever terms or agreements made by the current partners regarding the disposition of the firm? If you were in the retired owner's position, would you be comfortable with this level of ambiguity regarding the viability of your payout?

From our perspective, if a merger or sale looks so good to the current owners that they can't pass up the opportunity, then one of two things should be easily managed:

1. The deal will be easy to sell to the retired partners to assure them of their full retirement payout.
2. The deal will be good enough to justify a complete payoff of the retired partners.

Remember, paying off the retired partners is not an added expense to the firm, just an accelerated one. We recommend your agreement be structured to allow the retired partners to block a sale or merger or to allow them to be taken out of the decision by paying them off. A good retirement benefit policy will have a present value calculation identified for early payoff anyway, so there is really nothing negative about providing this extra protection to those who have already served their time.

Ability of the Retired Owners to Block the Sale of a Line of Business Unless the Retirement Obligation Is Paid in Full Prior to the Transaction

In the case of a sale of part of the practice, it could be that the retired partner might be left in a more precarious position with regard to collecting his or her buyout. Less than 10 percent of firms address this in their buyout agreements. Here again, we feel that the retired partners should be able to hold the firm accountable for a front-end cash payment from the sale of a line of business if that sale will significantly reduce the bottom line of the firm. Most retirement provisions carry a cap about what portion of net income will be paid to retired partners, so a material reduction in net income could have a negative affect on retired partners while the current partners line their pockets with cash from the sale of the line of business.

What's material? It depends on the facts and circumstances. The more retired owners you have collecting monthly buyout checks, the lower the threshold of materiality for changes in net income. Generally, we would recommend that the retired partners be able to block the sale of a line of business that represented approximately 20 percent or more of the top line or 10 percent or more of the bottom line (the firm situation, size of the firm, number of partners, amount of debt owed to retired partners, and so on all affect where this line should be drawn). You also could have a provision that overrides the retired partners' ability to block the sale of a line of business if the entire purchase price, net of expenses (that is, the total net proceeds), goes toward paying off the outstanding retirement obligation of the firm. This way, even if a sale represented more than 10 percent of the net profits and even if the retired partners objected to such a transaction, the firm would not be restricted from consummating the deal as long the retired partners received the benefit. As

we previously discussed, if something is a good deal, the existing partners shouldn't have a problem obtaining the necessary agreement to move forward from the retired partners. Even if the retired partners are being disagreeable, the provision we just mentioned would take care of that. If the current partners are trying to access a windfall of cash and leave the retired partners out, then the deal deserves to be blocked.

Insurance Coverage of the Outstanding Retirement Obligations

A complete discussion of using insurance products in buy-sells and succession planning is beyond the scope of this material, but it is worth noting that, although this seems like a no-brainer, due to some people's preexisting health conditions, not everyone can qualify for buyout insurance. For those who can, we believe it makes sense to consider buying as much insurance as you can afford up to the buyout value, thereby funding a buyout at 100 percent in the event of the death of an owner. Although any insurance coverage at death is better than none, we suggest that you look at funding as much of the value as possible for a buyout due to death and closely monitoring the changing value of those obligations so that you can increase the coverage as warranted.

What if an owner passes away before he or she retires? Here again, we see a variety of approaches, which typically range from paying out

- 100 percent of the benefit as if the partner was fully vested, regardless of current age or vesting.
- some arbitrary portion of the fully vested amount, regardless of age or vesting, usually in the 60 percent to 75 percent range.
- only what the partner was fully entitled to upon the date of death, which could range from nothing to the amount actually vested.

We recommend that you consider paying out something less than 100 percent of the fully vested amount if the partner has not met minimum vesting requirements or if the partner has not started the client transitioning process. The reason we suggest this is because the firm will incur some costs due to the instant loss of capacity and capability. Although most clients typically will not jump ship when a partner dies, you still will need to deal with covering the client responsibilities by promoting someone to partner earlier than planned, hiring another high-level person, and so on to provide the necessary capacity to serve the clients of the deceased partner. Although people want to be generous about such a horrible tragedy, in the continuation mode, you have to consider the firm as a separate entity and create policies that protect it and its ability to survive and prosper, not burden it with obligations it can ill afford.

Some firms take their insurance practices to another level and view those policies as investments for the future. They often will hold policies on partners not only through the payoff period but long afterward, inasmuch as they look at insurance as a risk management strategy that eventually converts into a cash windfall opportunity for retired partners with quickly deteriorating health conditions. Finally, some firms will allow the retired partner the

option of taking over the policy after he or she has been paid, but we would consider that a nice perk, not something the retired partner should expect.

Partially Funded Retirement Plans

In *The 2008 PCPS Succession Survey*, we learned that 67 percent of firms don't fund retirement and don't plan to. Another 12 percent said they don't, but they will. The rest of the firms are funding some percentage of buyouts. Although we recommend 100 percent funding via insurance products for a buyout due to death, we don't recommend full funding for lifetime buyouts. When owners know that some portion of their retirement funding is already in place, it takes much of the pressure out of the succession process. Therefore, you don't want to fully fund retirement because this basically is creating a system in which the seller pays him or herself in advance for the business and gives it to the remaining partners. When retirement is fully funded, partners tend to stop doing what they should do to ensure practice continuation because no risk or reward is left for them. A partially funded retirement (approximately 15 percent to 20 percent) allows the firm to have a safety net to pay the retired partners in case the firm has an off year (or two). This fund essentially serves as a backup reserve to pay the retired partners in case of short-term problems because the plan is to fully pay them from normal cash flow.

Acts That Can Trigger a Reduction or Discontinuation of Benefits

Earlier, we mentioned having a penalty for partners who don't properly transition their client relationships. In addition, if a retiring partner publicly disparages the firm at any time during the retirement pay off period, all payments should stop until damages can be assessed or public retractions occur. It comes down to this: with professional service businesses, justification for the purchase of a revenue stream is the expectation of the continuation of that stream and its related profits. If the retired partner has not properly transitioned the relationships or is undermining the marketing efforts of the firm through public disparagement, then the value assessed for a partner's interest in a revenue stream will be overstated by the lost clients or damage to the firm's reputation, or both. Just to be clear here, this policy typically is something we add at the end of the retirement policy, and it is used to stop payment, thus bringing a situation to a head so it can be settled. You will likely end up fighting in court if this can't be easily resolved, but this kind of clause provides the firm instant recourse should a retired partner forget that he or she needs to be supporting the firm as an ambassador during retirement, not bashing the firm just because he or she is no longer active in the organization.

Keep in mind that the retired partners are truly ambassadors out in the community. What they do and say and how they behave matters to your firm, and there should be downside consequences to them. We've seen instances when a retired partner told firm clients and others in the community that the remaining partners were weak, that they weren't

as good as him, and how he hoped they could keep the business going long enough to pay him out. This is not only uncalled for, it's just plain stupid, and if it happens to your firm, you need a mechanism to instantly address it.

Another activity that will trigger a reduction or discontinuation of benefits is competing with the firm. Your firm should not be in the business of generating new competitors. Any owner who leaves should be penalized if he or she competes with the firm. In *The 2008 PCPS Succession Survey*, we learned that more than half the firms have some type of provision to deal with this activity. The concept behind this provision is that when partners sell their ownership interest, they either work for the firm or they literally retire. They don't get the opportunity to start a side practice while they're collecting retirement benefits from their old firm. From a practical point of view, you really can't stop them from starting another practice or working for another firm, but you can stipulate that this type of activity will diminish or eliminate your firm's retirement benefit obligation to them.

Consider this example: a retiring partner who did litigation work wants his or her retirement benefits but, technically, doesn't have any clients, just referral sources, and the partner still wants to continue doing what he or she was doing before. This matter is something the firm should have addressed years ago in terms of the way the partners practice while recognizing that a one person, unleveraged, specialty consulting practice has no annuity value to the firm upon the partner's departure. At a minimum, the firm should have made sure that it was not incubating a competing practice while being set up to pay retirement benefits for virtually no value remaining in the firm. It's not fair to the firm to allow partners to build a business around themselves and then be able to walk away and make great money in retirement while receiving retirement benefits from a practice that they took with them.

Acts That Can Trigger a Change of Ownership

Any number of acts or actions by owners can and should trigger a change of ownership interests or retirement payout, including the following:

- Misconduct
- Illegal activities
- Lack of performance
- Disability
- Death

We discussed buyouts at death in a preceding section of this chapter. The rest of these issues will be covered in chapter 9 because they all affect the value of the firm, an owner's buyout, or an owner's current value of his or her share of the business. For the time being, it's important to note that the firm can force a retirement or terminate a partner for the issues previously identified. A forced retirement might occur or be offered if the firm wants a partner to leave and he or she is near retirement or agrees to leave on good terms, help with client transition, and so on. On the other hand, if a partner has years before he or she is eligible for retirement and it is time for him or her to go, simple termination might be in

order. Both of these actions (forced retirement and termination) affect the partner's entitled value, which we also will cover in the next chapter.

Conclusion

If you've performed the groundwork we've suggested in previous chapters and you approach the actual transition of your firm's owners in a fair and equitable manner by using this chapter as a guide, you should be ready to begin effectively transitioning retiring partners. Just remember that fair and equitable cuts both ways. The firm needs to be able to survive and thrive while paying off retired partners, without the remaining partners having to work excessively to make it work. At the same time, the retiring partners need to be appropriately paid for their contribution to the business. This chapter explained the issues that you must address in any internal ownership transition. As you can see, some of these matters must be addressed beginning from two to three years before someone is planning on leaving. If you haven't already started, there is no time like the present.

Appendix A

Sample Partner Transition Plan

Partner Name: _____

Planned Retirement Date: _____

Years until Retirement (3, 2 or 1): _____

Client Name: _____

New Client Service Partner: _____

Planned Action/Activity: _____

Date: _____

Done Properly (Y/N) _____

Planned Action/Activity: _____

Date: _____

Done Properly (Y/N) _____

Planned Action/Activity: _____

Date: _____

Done Properly (Y/N) _____

Planned Action/Activity: _____

Date: _____

Done Properly (Y/N) _____

12 th Qtr	11 th Qtr	10 th Qtr	9 th Qtr	8 th Qtr	7 th Qtr	6 th Qtr	5 th Qtr	4 th Qtr	3 rd Qtr	2 nd Qtr	1 st Qtr

Client Name: _____

New Client Service Partner: _____

Planned Action/Activity: _____

Date: _____

Done Properly (Y/N) _____

Planned Action/Activity: _____

Date: _____

Done Properly (Y/N) _____

Planned Action/Activity: _____

Date: _____

Done Properly (Y/N) _____

Planned Action/Activity: _____

Date: _____

Done Properly (Y/N) _____

12 th Qtr	11 th Qtr	10 th Qtr	9 th Qtr	8 th Qtr	7 th Qtr	6 th Qtr	5 th Qtr	4 th Qtr	3 rd Qtr	2 nd Qtr	1 st Qtr

Client Name: _____

New Client Service Partner: _____

Planned Action/Activity: _____

Date: _____

Done Properly (Y/N) _____

Planned Action/Activity: _____

Date: _____

Done Properly (Y/N) _____

Planned Action/Activity: _____

Date: _____

Done Properly (Y/N) _____

Planned Action/Activity: _____

Date: _____

Done Properly (Y/N) _____

12 th Qtr	11 th Qtr	10 th Qtr	9 th Qtr	8 th Qtr	7 th Qtr	6 th Qtr	5 th Qtr	4 th Qtr	3 rd Qtr	2 nd Qtr	1 st Qtr

Indicate (Y or N) whether the partner has met the transitioning requirements for each quarter, shown as duration until retirement

Chapter 9



What Is the Value of My Firm?

Introduction

We are now going to cover the financial package in practice transfer transactions. Just in case you've skipped ahead to this chapter, we are assuming that you will go back and review the preceding chapters in order to prepare your firm for whatever change you have in mind. The preceding chapters cover a variety of techniques that allow you to position your firm to optimize its value. Firm owners who wait too long and can't make the required changes could end up with a business that is not of interest to the marketplace.

As you know from previous chapters, we predict that the market for CPA firms will soften over the next decade. In some geographic areas today, especially rural markets, this prediction is already coming true, and we expect it to get a lot worse before it gets better. However, even in a buyers' market, well-run, profitable firms with trained staff should still have plenty of suitors. So, the value we are talking about in this chapter assumes you are taking the necessary steps to maintain a viable business. The next several years will be an interesting time for CPAs hoping to retire. You have time to make a difference in your practice and your pocketbook. You can do it if you make this a priority and you start now.

We'll take a look at the current trends in valuation of CPA firms for internal transfer, purchase or sale, and merger (both upstream and downstream). The financial package

includes the various terms associated with a deal, such as payment duration, financing, non-compete agreements, and so on. We'll also be getting into the details of other conditions or constraints, as well. Just keep in mind that there are about as many different approaches as there are firms.

We have broken this chapter into two sections: the first covers external value and the second covers internal value. We define *external value* as what you might expect from an arm's length transaction in an acquisition or merger. *Internal value* is what you might expect when you sell your share of ownership to your partners.

In our next section, we are going to cover some results from *The 2008 PCPS Succession Survey*.¹ Although this data is more focused on the agreements people utilize to determine the internal value of buying out a partner, it tends to drive the expectations and reality for external value as well. Any time the marketplace gap between external and internal value becomes too large, one of the partner groups will force the gap to be narrowed. Otherwise, rather than selling to each other, the value delta will motivate unintended consequences, such as split-ups and spin-offs, so that the remaining or retiring partner groups can make the clearly better deal.

The Three Most Common Methods for Valuing an Ownership Interest

General Methods Used to Calculate Retirement Payouts	
Multiple of book	23%
Multiple of ownership percentage	17%
Salary	19%
Other	41%

The 2008 PCPS Succession Survey identified three primary methods of valuing a CPA firm owner's interest. The preceding table shows the results of the survey.

The survey contained a large number of "other" responses—41 percent of the total; these responses included answers ranging from "We have not agreed on a payout formula" to "N/A" to "An agreed-to amount" to "Described versions of the formulas above with some additional explanation." Based on the "other" responses, it is clear that these three methods plus an agreed-to amount are the four predominant variations.

Another method that is starting to gain momentum is a multiple of profits, similar to what many of you probably consider in valuing your clients' business. This method can be confusing because some firms use earnings after planned partner compensation, and others use the earnings number before partner compensation. We suspect that this method will gain in popularity over time as these issues are worked out.

Looking at the three most popular methods previously identified, the responses were as follows:

- Book of business that, typically, is currently valued from \$0.75 cents to \$1.00 for every dollar of revenue

¹ AICPA. *2008 PCPS Succession Survey*. The Succession Institute, 2008.

- Multiple of salary with some multiple of the average of highest compensation (at this time, the most common multiple is three times average salary)
- Ownership equity percentage of total revenue of the firm, which is typically valued at \$0.75 cents to \$1.00 for every dollar of revenue at this time

For firms using a calculation based on annual volume of the firm or partner book size, 49 percent are using a multiplier of 1.0 or greater, and 30 percent are using a multiplier of 0.75 or less.

Thirty-eight percent of firms utilizing partners' compensation as a primary factor for calculating retirement payouts are using a factor of three times average salary, with 13 percent using a higher factor and nearly half using something less than three times average salary.

Based on the survey results, the book of business approach seems to be used slightly more than either of the other two methods. Part of this is due to the fact that many of the respondents are functioning under an "eat what you kill (EWYK)," or superstar, model of business, and to some extent, the survey results also are skewed by the smaller firms' responses (because the vast majority of CPA firms fall into the smaller firm category). It's no surprise that the multiple of salary came in a close second because most larger firms have been using this method for a long time. The ownership of equity percentage method, which usually gains in popularity as smaller firms grow out of the book of business approach (EWYK) and try to move to the "Building A Village," or Operator, model of business, came in a close third.

Multipliers—Revenue or Book Size	
More than \$1 for the \$1	7%
\$1 for the \$1	42%
\$0.95 on the \$1	2%
\$0.90 on the \$1	3%
\$0.85 on the \$1	2%
\$0.80 on the \$1	7%
\$0.75 on the \$1	14%
\$0.70 on the \$1	3%
\$0.65 on the \$1	3%
\$0.60 on the \$1	4%
\$0.55 on the \$1	1%
\$0.50 on the \$1	4%
Less than \$0.50 on the \$1	1%
N/A	6%

Multipliers—Salary	
Less than one year's salary	6%
One year's salary	8%
One year's salary times 1.5	3%
One year's salary times 2	17%
One year's salary times 2.5	14%
One year's salary times 3	38%
One year's salary times 3.5	3%
More than one year's salary times 3.5	5%
N/A	5%

Methods Used to Calculate Retirement Payouts—Detail	
Retiring partner's book times an agreed-upon value (for example, \$0.75 cents on the dollar) plus capital plus share of book value	9%
Retiring partner's book times an agreed-upon value (for example, \$0.75 cents on the dollar) plus capital	9%
Retiring partner's equity ownership times net revenues at an agreed-upon value (for example, \$0.75 cents on the dollar) plus capital plus share of book value	9%
Retiring partner's equity ownership times net revenues at an agreed-upon value (for example, \$0.75 cents on the dollar) plus capital	17%

(continued)

Methods Used to Calculate Retirement Payouts—Detail	
Retiring partner's average salary over a number of years times a multiple (for example, salary times 2.5) plus capital plus share of book value	5%
Retiring partner's average salary over a number of years times a multiple (for example, salary times 2.5) plus capital	12%
Some agreed-to-in-advance number for each partner	11%
Other	28%

The preceding graphic expands the discussion on methods used to include common variations. As we mentioned earlier, many of these comments also were found in the “other” category. As you can see and as we have found, when it comes to calculating a value for a payout, there seems to be about as many different methods as there are firms. The preceding table illustrates some common variations. Some firms use the straight formula previously introduced, others add capital, and still others add a share of book value. The large percentage of “other” responses was predominantly some variation of “N/A” or “no agreement yet.”

External Value

Typical deals found in the marketplace for buying and selling or merging practices vary widely, depending on the unique circumstances of the firms involved. The variations are almost limitless, but for the sake of this chapter, we want to at least cover some of the more common alternatives with which we have been involved or that we've heard about. The following subsections will discuss typical deals made to acquire or merge CPA firms. Some of the materials from this section were excerpted from the book *Securing the Future: Succession Planning Basics*.

Typical Acquisitions of CPA Firms

Acquisition Multipliers

Most acquisition stories have a multiplier of revenue in common. Over the last 20 years, we have seen that multiplier range anywhere from 50 percent (0.5) to approximately 225 percent (2.25). Today, revenue multipliers ranging from \$0.85 to \$1 for each dollar of revenue are most often quoted as examples. Rarely do we hear of numbers in excess of a dollar. However, as you will see in our following example, this benchmark can be very misleading.

Acquisition Purchasers

In the past, there have been several times in the history of our profession when firms would go on a buying frenzy, acquiring as many firms that met their criteria as they could. This activity temporarily created a supply and demand anomaly that drove up market prices, especially when the criteria for acquisition were loosely defined. We saw this phenomenon originate from the corporate marketplace, with mergers such as American Express and H&R Block (as defined in an earlier chapter, a *mergor* is a firm that is either acquiring another firm or the firm into which another one will be folded). In today's marketplace, these

transactions are not coming from the big consolidators but from local and regional firms looking to expand geographically or in terms of services, industries, or volume. For the most part, firms in the market today are not willing to buy just anyone. On the contrary, they are looking for firms that will add synergistic value to their current strategy and offerings, with minimal reorganization costs.

This more constrained and conservative approach to acquisitions and mergers is the result of years of experience in this area. Merger firms have found that when diverse cultures collide, the result is often a terrible explosion that creates casualties for all sides. Firms have discovered that owner competencies, roles, responsibilities, and accountability can be extremely different from one firm to the next. Unfortunately, the idea that all owners can easily be reshaped was fabricated on the same logic as the process of herding cats. The philosophy that two firms will be far better off by uniting their superstars has over and over yielded friction and annulment as power struggles fragment the new firm. The misguided belief that all clients are good clients has led to the purchase and then the fairly immediate firing or loss of those clients as a result of issues of price sensitivity, profitability, or negligible opportunity for service expansion.

The presumption that two well-run firms with strong processes and methodologies will seamlessly combine has too often led to a loss in accountability; organizational chaos; and controversy over hierarchy, procedure, and policy. All of this has generated the recognition and observance of a success factor critical to the merger and acquisition process. Once the merger firm has found a synergistic target firm with seemingly compatible cultures, comparable personnel expectations, and a fair price, any transaction that takes place will come with the following caveat from the merger firm:

Although we will listen to your ideas and we are willing to consider your suggestions, only one firm can be in charge. By agreeing to join us, you need to be clear that everyone in your organization will be forced to conform to our way of operating the firm.

Without clear communication on this important point, the entire organization will become confused by the politics and power struggles that begin to rip the fabric of the institution. It is this reorganizational cost that has been the most damaging to firms that have sustained it. The most frequent response from the managing partner or CEO on this topic is, "It wasn't the money we spent that was so detrimental. What was most destructive was the internal chaos, the loss in organizational direction, and the time and resources required to not only unravel parts of the deal but remove the people who could not be salvaged." To take this a step further and demonstrate the experience of a typical acquisition or merger, the following story is commonly told:

Facilitator: "So, how successful has your acquisition or merger strategy been?"

Client: "It is working fine. We bought numerous small firms over the past 15 years and merged in a couple, as well."

Facilitator: "Could you summarize the most recent acquisition or merger?"

Client: "Well, we bought a firm with an \$800,000 book about 5 years ago from a partner who wanted to retire. He worked with us for approximately 1 year before he retired. We originally planned on him staying around for several

years, but he was too disruptive so we told him he didn't have to stay the entire period. We got a few good clients from the deal; several are still our clients. We got a great manager and she is currently on our partner track, but most of the others didn't really fit. The best news of all is we made our last payment on the deal approximately 2 years ago."

Facilitator: "If I can summarize, what I am hearing is that you paid about \$800,000 for a firm..."

Client: "Stop. No, we didn't pay \$800,000. We probably only paid \$500,000 because we ran off a good number of his clients right at the beginning."

Facilitator: "OK, so you paid \$500,000 for a partner to transition the work, which he did such a bad job of that you let him go early; it took you several years to get rid of a number of marginal employees; you have kept about \$300,000 worth of clients; and you salvaged 1 manager who's on your partner track. Is that the story?"

Client: "That about sums it up."

The point is that, at best, mergers and acquisitions come with a great deal of baggage. Most firms simply look at the price paid, but from our experience, the real cost—the hidden cost—is clear, as in the preceding story. That real cost results from the chaos that occurs and the management focus required to clean up a spiderweb of issues so that the firm can get back on track.

Acquisition Structures

The challenges inherent in the merger and acquisition experience have led firms to conduct much more complex and comprehensive investigations pertaining to the culture and operating processes before a deal is seriously considered. Let's take a simple example regarding client makeup. Years ago, a buying firm might have offered the seller a simple deal of \$1 for each dollar of gross revenues and closed the deal with no look-back period or reduction for lost clients. Today, you might hear someone express a willingness to pay that same amount but with caveats, such as the following:

1. The price is a rough prediction of a weighted average paying different values for different business segments. For example, we will pay you \$1.20 for each dollar of revenue for your audit clients, \$1.10 for your corporate tax clients, but only \$0.50 for your individual tax clients and bookkeeping work.
2. We would only pay you for the clients that you transition to us and who we keep.
3. There would be a cap per client based on last year's billings. Should we bill the client more, that is our gain. Should we bill the client less, that is your loss.
4. We will pay you 25 percent of the total due based on what we bill your client base each year over 4 years, with that amount limited based on the per-client cap and then multiplied by the proper valuation for that business segment (see number 1).

Although some brokers will tell you they do deals all the time for a fixed price up front with no retainer caveats or look-back provisions, we don't see them. Most likely, our clients are just too savvy. Would you buy anything, either an internal or external deal, where you pay the money up front with the retiring partner having no consequences or accountability

for what he or she is doing, has done, or has promised to do but does not deliver? So, we believe that these deals should be paid over a short time span (we like four years but are happy with three), based on the clients who we decide to keep. In our small view of the world, this is a far more common picture of what is happening than cash up front with no accountability.

Sometimes, when a mergor buys or merges in a firm, it is willing to pay a premium over market. Premiums are often used to motivate deals that might not otherwise come together or wouldn't come together in the time frame that interests the mergor. For example, the acquisition target may have people with a specialty skill, talent, or niche that the mergor really wants to build up; the mergee firm may be in a location the mergor has strategically targeted (with an acquisition or merger saving the mergor hundreds of thousands of dollars over opening an office from scratch); or the profitability of the firm being acquired could be much higher than normal.

Typically, most premiums are paid through one of the following methods:

1. Offering more than \$1 for each dollar of revenue.
2. Placing the cap described earlier on total revenue, not on the client level of revenue. This would allow the selling firm that has lost money due to dropped clients from the mergor firm to have a chance to make up some or all of that, with growth in business from the clients being kept.
3. Agreeing to a floor on the revenue number.
4. Allowing the acquisition or mergee firm to share in any growth that occurs during the look-back or payout period. This may be a simple, straight calculation, or it might be one that diminishes. For example, you might pay a firm dollar for dollar for the first \$150,000 of growth, then \$0.75 on the dollar for the next \$150,000, and maybe \$0.50 for anything above that for the duration of the payout period.

All of these occur; however, in most deals, they are the exception and not the standard terms. Most firms being acquired don't have exceptionally trained people; premium-level profits; or strong, well-known specialty niches. If they did, most likely, the firm's owners would be selling to their internal people rather than through an external transfer, such as an acquisition or merger.

The point is that, in today's market, after everything is said and done, if you sell your practice for the price of \$1 for each dollar of revenue retained, this will still likely only net you (as the seller) between \$0.60 and \$0.75 cents on the dollar unless your firm is exceptional enough to be granted some premium privileges (and most firms are not).

This brings up a common point of confusion: we often hear that you will make more by selling your book or practice externally rather than internally. It might be that you have no confidence selling internally, so you discount ever being paid in full. Other than this assumption, we have not found external deals to be more lucrative than internal deals. Although the multiple you are offered might be higher from an external buyer, we find the net you will get paid will be lower. On the rare occasion when we work with a firm that has created a retirement formula of something less than market, we push them to "make it right." This isn't because we don't want the junior partners to get a deal. In our experience, it's because when this is the case, most of the time the senior partners will just sell or merge the firm so that they can receive a closer-to-market benefit package.

Here is our belief: the junior partners are willing to pay a certain number in excess of market, and the senior partners are willing to take a certain number below market. For simplicity, we usually quote the 20 rule. Junior partners might be willing to pay up to 20 percent more than what a partner's share of the business is worth and a partner might be willing to take up to 20 percent less than his or her share of what the business is worth, but the closer you get to these extremes, the more you are asking for something bad to happen (for example, a split or a forced sale or merger). When this condition exists, and, unfortunately, it occurs far more often than it should, it is often about greed. Someone wanted more than they deserved for what they were offering, with a result that's worse for everyone.

Here is why we see internal purchases or retirement benefits as more lucrative than an external transaction. It is straightforward business logic. The internal transaction requires far fewer changes for the continuing or take-over parties. Change creates discomfort, and the absence of that discomfort usually drives a willingness to pay a little extra. Think of it this way: when junior partners buy out a senior partner, they are not being asked to change cultures, operating systems, technology, clients, and so on. When the senior partner retires, the junior partners have the luxury of continuing to work with the same clients and staff, doing almost exactly what they were doing before retirement. When someone buys or merges in a firm, clients are being asked to change firms, and partners and staff are being asked to adapt to a different culture, set of policies and processes, technology, and more. In other words, everything is changing for everyone. Therefore, logic demands that the external market should be paying less—net-net because buyers or mergers have an exceptional number of integration, organizational, and structural issues, which carry the high price tag of nonchargeable resources, downtime, relearning, acculturation, and much more. Most of the time, our experience has been that the marketplace reacts in line with what we have described.

The exception to this has come from sole practitioners or small practices of several hundred thousand dollars in annual revenue. Often, these deals are done for a variety of reasons, and up front cash deals with no look-back provisions are more common. In these situations, a staff member, access to a couple of clients, eliminating competition in a small market, or just the size of the transaction might be driving the justification to structure the deal simply and get it done. Think of a buyer of real estate who only has an interest in the land, not the house: the buyer doesn't care what the house inspection uncovers because he or she is just planning on demolishing it anyway. So, a firm might buy a practice in a small rural town just to take out the low-end price competition so that there is less resistance to its own fee structure, rather than allowing someone to continue that firm with similar pricing practices. However, don't confuse one of these strategic moves as a reflection of market price.

Acquisition Networks

Another marketplace mechanism, which is often a precursor to acquisition, is for small firms to band together through strategic alliances, networks of firms, or overhead and office sharing arrangements. Because it has become increasingly difficult for sole proprietors and small firms to handle the vast array of work their clients are demanding, more and more small firms are coming together to assist each other. Although these arrangements run the gamut

from simply sharing specific overhead while keeping the businesses totally separate to combining the businesses but splitting profits on an “eat what you kill (EWYK),” or superstar, basis, these arrangements are providing these small firms with advantages. Benefits include access to additional staff when needed, reductions in operating costs, quick access to peers to exchange ideas, and groups to whom they may sell their clients when the time comes. We not only believe that this option will continue to build momentum on its own, but it will exponentially explode when for-profit groups and CPA societies put together localized networks seeded with agreements, talent-sharing policies, billing procedures, practice continuation agreements, and succession plans. Note that we believe these networks will flourish when they are built around quality standard operating procedures (SOPs) supporting an EWYK model that allows the group to run smoothly within the administrative structure created.

Typical Mergers of CPA Firms

Merger Sellers and Purchasers

The primary driver for most merger transactions is the creation of an exit strategy for one or more of the senior owners of the mergee firm. Small firms are joining larger firms to ensure that their clients can continue to receive quality services while the owners are simultaneously being assured that their retirement benefits are financially secure. As you might imagine, the snag in these deals usually comes from answers to the following questions:

1. How long do the senior owners have to work for the merged firm?
2. What will be the owners' base salary, and how will their annual compensation be derived?
3. What guarantees exist? Are there none? Is there a one- or two-year guaranteed salary?
4. Most importantly, how is the retirement benefit to be calculated? What will it likely be, and when are the owners eligible to start drawing it?

Merger Structures

Currently, the merger deals being executed involve minimal to no cash. They are more a pooling of assets than anything else. Although the mergee firm might get to keep its cash in the bank (partially to pay the payables), typically, the receivables, work in process, and whatever fixed assets are considered valuable to the new firm form the basis of the new owners' capital accounts and credit to determine the ownership percentages granted the new partners (in other words, you move your balance sheet into ours and we give you credit for it). If those amounts fall short of the merger firm's minimums, then it is common to negotiate a time frame for the new owners to bring their balances up to expectations.

For the larger merger firms, the deal they typically make to mergee firms is join us, and

1. we will put our name on your door.
2. the partners—those of your owners whom we accept as partners—will be entitled to our retirement benefits package (usually some multiple of salary, sometimes with some consumer price index adjustment).

3. for a year or two, we will guarantee the partners' minimum compensation at what they have been making or a little more.
4. because you will be part of our bigger firm, you will be able to sell services to larger clients, which will give your office access to more profitable work. Although the partners are likely to share a little in the overall success of the firm, most of the compensation centers on office profitability.

Some (but very few) firms will kick in a little money up front to sweeten the deal, maybe as much as 15 percent. When they do this, expect something to offset the money on the back end. No one would pay a 15 percent premium without an offset somewhere else; otherwise, everyone would be selling or merging with the same firm. When cash is on the table, the mergor firm wants to make sure most of it is directed to the partners who are staying, not the partners who are leaving. It should come as no surprise that the senior owners of the mergee firm are pushing for exactly the opposite.

Although it is far less common, some firms are looking at the acquisition and merger market from a multiple-of-profit perspective. Given that most businesses in the United States trade on this type of model, it is predictable that this approach will become more and more commonplace in our profession over time. Profitability is looked at in two key ways: total profits (excluding all partner payments, which would be consistent with the generic small business market model) or excess earnings of partners (the more corporate model). Depending on which one is used, the multiples will be different. We have heard of numbers being tossed around between 2 and 8 times, with 3 or 4 times being the target multiples for the excess earnings variation.

Regardless of the pricing approach—whether it be offered as a percentage of net revenues, size of a book, or a multiple of profits—firm profitability, client mix, ease of assimilation, and staff talent levels and availability (a right side up pyramid with appropriate numbers of staff at every level) affect the “cents on the dollar” or “multiple” being contemplated as the price of the deal. For example, a recent deal for marginally profitable work, poor client mix, but a good staff mix ended up at approximately \$0.50 on the dollar for a firm with millions of dollars in revenue. Without the good staff mix, the deal would have been significantly less than \$0.50 or, most likely, not even a deal at all. Logically, the variables previously mentioned will have either a positive or negative effect on the adjustments that will be proposed.

Adjustments that are ordinarily considered to offset the various identified inequities, either pro or con, would be the following:

- *Salary guarantees.* Minimum salary guarantees typically at current or higher levels, but the guarantees could be lower, as well.
- *Retirement formulas.* For owners who will be retiring soon, the mergor firm might establish a minimum annual salary and freeze the retirement amount so that these owners can focus their time on transitioning their clients. The reason for this is because some retirement formulas increase with firm growth. If the partner is only coming in long enough to transition clients, then the firm might freeze his or her benefits at the levels at which the firm is operating at the time of the merger. If the

mergor firm is trying to sweeten the pot, it could identify a minimum retirement benefit but also let the partner share in the success of the organization until the day he or she actually departs or sells his or her ownership.

- *Adjustment to the variables.* A number of retirement systems have both a years of service component and an age component, which affect the retirement calculation. Most firms will tinker with these variables, making either positive or negative adjustments to reflect the exceptional or marginal characteristics of the target firm. For example, adding to the years of service or the years of age, or both, are examples of trying to reflect a premium value for the unique niche or profitability of the target firm being merged into a fixed retirement system.
- *Ownership allocation.* Agreements in a number of mergers will freeze the gross income or profitability of the firm at the time of the merger, but others will consider changes to revenues and profits for some period of time after the merger for ownership and benefit allocation purposes. For example, a firm might make negative adjustments against owners versus what would have been calculated on day one of the merger because of key clients lost during transition, especially when those clients were an impetus to the deal. To satisfy a different situation, that same firm might allow the allocated revenue and profit numbers to upwardly adjust and be credited to the mergee firm's owners to reflect new services sold during a specific window of time. In other words, an ownership percentage is calculated when the deal is consummated, but that percentage can be adjusted up or down based on the performance of the partners during a specific window of time.
- *Partner slots (the number of partners in the mergee firm who would be made partners in the mergor firm).* This is always an issue in any negotiation. It is common for some partners in the mergee firm to be brought over to the mergor firm as senior managers. This is because, in smaller firms, the criteria (statistically, economically, technically, competencies, and so on) to become a partner often are less formalized. As firms grow larger, the reverse is true. So, although it might be commonplace for a \$2 million firm to have 4 partners, in larger firms, just on volume alone, only 2 partners could be justified (and, more likely, just 1).

No matter what adjustments are made at the time of the merger, most of these arrangements, except for those affecting retirement, will quickly default to everyone operating within the firm's operating procedures and processes. It is a bad practice to cut every partner a deal of his or her own. So, if the mergee firm owners are offered guaranteed minimum salaries, then all of those salaries are likely to be guaranteed for the same period of time. After that protected period, owners will have to earn their money based on whatever performance system is in place.

In years past, some firms made the terrible mistake of cutting special long-term compensation contracts not only with each merged firm but with different owners within each firm. This backfired because, rather than having a united owner group working to achieve the firm's strategy, the mergor firms ended up with multiple owner groups managing their own disconnected compensation strategies. Silos appeared everywhere, with the owners'

personal interests in direct conflict with firm interests. Until these owners had their contracts renegotiated, were paid off, or were retired, the mergor firm was trapped within its own expansion success. Firms learned very painfully that adjustments to compensation or retirement had to be made within one existing framework, or the mergor firm's theoretical step forward through merger could easily become a couple of steps backward.

A strategy we strongly recommend with any merger is an opt-out agreement, so that either party can walk from the deal. This allows a new owner a window of time (often no more than one year, but we work with firms that default to two years) to determine whether he or she can operate within the mergor firm's organization. If the owner cannot, he or she has the right to leave and take his or her clients, assuming the identified financial issues have been resolved. (This is commonly a process of adjusting the departing owner's total payments during the trial period so they are commensurate with some percentage of the money he or she directly generated during this time.) The same is true on the other side: the mergor may want the right to disconnect the mergee firm. This desire to annul the merger may be due to a conflict between the owners of the two firms, personal differences, ethical perspectives, an unwillingness of the mergee firm partners to be held accountable to the mergor firm's processes, and much more. Interestingly, in our experience, when this clause exists, most often the mergee and mergor firms waive their right to this clause within the first nine months because both parties know what they are getting and want to put the possibility of splitting up behind them.

Two schools of thought exist regarding opt-out agreements. One is that you want to penalize whichever firm uses the opt-out escape clause because it has wasted the resources the other firm has put into integrating the two firms. This makes sense because integration, training, and indoctrination are time consuming, expensive, and resource intensive (especially because the hardship is more often due to the consumption of scarce resources versus the cost of those resources). However, we prefer no penalty because we don't want a financial penalty to be the reason a deal holds together. When a financial penalty becomes a strong influence on the break up decision, the firm likely will be the beneficiary of inaction (meaning, people stay when they want to leave). This will result in unnecessary and constant conflict, poor unity in the partner group, growth in passive-aggressive behavior, too much outside-of-meeting politicking, and an inability to accomplish as much as the firm should because of a lack of a unified strategy and structure. We like the fact that an opt-out agreement shifts attention away from penalty and toward the rules of the break up. (We covered this concept in more detail in "The Opt Out Clause" section in chapter 5.)

Merger Hybrid Strategy

A hybrid merger and acquisition strategy that you are likely to encounter more and more frequently is that rather than buying or merging with an entire organization, firms are soliciting niche, industry, or specialized teams of people to join them. For instance, if a firm needs additional support for one of its niches or is interested in building a new service or industry specialization, it might go out and find a small team within a competitive firm and "make them an offer they can't refuse." Although these firms might pay a nice bounty to their new employees for a niche-specific group of clients to transition with them, many

are more interested in acquiring the expertise and are happy to pay their new employees to rebuild the niche business from scratch. Who would have thought that a group of CPAs with no clients but a strong specialty expertise would be considered a good merger target? Logically, most firms have not put anything in place to address this possibility because the traditional thinking is that owner groups merge as a whole. So, buckle up and get ready; the stage is set for some very interesting deals in the decade to come.

By the way, it is during deals such as this that exceptional pricing can be found. It might be worth paying high signing bonuses and twice the market rate for client revenues to get access to a niche service group synergistic with the mergor firm. However, just as we discussed when we mentioned the small firm cash deal earlier, don't mistake a strategic buy or merger with market price. When you consider the cost of recruiting, paying headhunters, advertising for specific skill sets, perks, and bonuses to move people from one city to the next, it could be significantly cheaper to carve out part of a local competitor's firm than build your own niche service group from the ground up.

Internal Value

As you move closer to retirement age, you probably will develop or have developed some idea about what you're entitled to upon the sale of your interest to your partners. Most likely, at least some of your younger partners will have formed an idea of what that should be, too. The senior partners are likely thinking that they have built an asset worth far more than real market value, but the junior partners will just as likely be thinking along the opposite extreme. We often find that in firms lacking a properly thought out retirement SOP, there are unreasonable expectations on both sides of the issue. We have covered many of the emotions creating and supporting these positions in chapters 4–5, and 7. Just as it is a pet peeve of ours for the senior owners to ascribe all the value of the firm to themselves, it is just as frustrating for us to hear junior partners saying, "I am not sure I am willing to buy you out at a fair price [the *fair price* words are not said; we filled that in] because the economy is softening, and I am not confident that we can make enough money to pay you off."

We have been beating up the senior owners for most of this material, but the tide is shifting. Partners who think that there should be no risk in running a firm, that their future success needs some kind of guarantee, and that they should be given a business rather than be on the hook for the liability to pay for it are wanting the upside of entrepreneurship without the risk. Financially speaking, our profession has made it far easier than ever for younger people to buy into firms. They often don't have to go to the bank and borrow money; they don't have to sign personal guarantees; and, often, some money is set aside to help with the purchase. Yet, some junior partners still struggle with paying market price. This is why we predict a problem in the softening of buy or merge prices in the CPA profession: too many senior partners want too much, and just as many junior partners don't appreciate what they are being offered. When you combine the two disparate views of value along with the demographics we discussed in chapter 2, we see a perfect storm brewing that should create havoc in the acquisition and merger marketplace in the coming future.

For those groups who are ready to step up and create and live by a framework to pass their firm to the next generation of leaders, we covered the need to develop infrastructure and leaders to allow the firm to continue (chapters 3 and 7), and we addressed the need to properly transition the work and client relationships from the retiring partners to the remaining partners (chapter 8). From this point on, the material assumes you are taking those steps and are now looking for a fair structure for your internal sale.

Why Your Remaining Partners May Want to Discount Your Buyout

We will cover the predominant methods of internal buyout valuations subsequently, together with our preferences. First, we'd like to address this notion of the younger partners not wanting to pay what the retiring partner wants to receive. Consider the different modes of operation we introduced in chapter 7. Many firms with retiring partners are functioning in the success mode. This means that the firm has evolved to the point of finding ways to enhance the success and profitability of the firm through maximizing the talents of its people under the control of the founding fathers. Not a lot of interchangeability exists among the "parts," which are the people, from the top down. More or less, positions are built around each person's skill set, rather than in a way that allows a variety of people to excel in any particular position.

What this means is that when a senior partner leaves, the remaining partners perceive a loss at three different levels:

1. *Raw charge hours and production.* Typically, the partners have been the workhorses and have been charging the highest rates in the firm. Even if their charge time is not the highest, due to their rates, the dollars they have produced have been the highest amounts in the firm.
2. *Technical competency.* The senior partners usually are the people who have developed a deep level of competence over a long career and are the subject matter experts that clients and the rest of the firm turn to for expert answers and assistance. Although you can arguably replace the charge hours through delegation to other people or new partners, it is difficult to replace the intellectual capital that these partners take with them once they are gone.
3. *Client relationship management.* As we've previously mentioned, a key factor in the ongoing success, growth, and profitability of any firm is client relationship management. The primary duty of a partner is to oversee the client relationship and the provision of services to the client in a way that builds client loyalty within firm policies for target client profiles and profitability. Although these client relationships can and should be transitioned before a partner retires, the process takes time and a deep commitment from the retiring partner and the partners to whom the relationships will be moved.

Due to the tendencies created in the success mode of operation, people haven't really been developed as they should have been, and this creates the problem of having to replace all three critical resources at once. For many firms, this is too much to ask. The moral of this story is that if you want to maximize your options and the value of your firm (and your

buyout), you should consider moving to the continuation mode of operation. The less prepared your firm and people are for your departure, the less value there is to your ownership interest. Stated in another manner, the retiring partner should expect less of a retirement benefit if the solution to filling the voids created by him or her ends up being the remaining partners increasing the number of hours they work by 200–400 hours or more.

In most small firms, the partners are already working more hours than they should be, so the requirement to work even more is not only unhealthy but, in many cases, unrealistic. Just so you know, at a recent conference, we asked the managing partner group how many hours their partners worked. (The average firm size was more than \$15 million in size.) The answer was 2,300–2,400 hours. If only this average were true of the smaller firms. For many in smaller firms, the work hours are several hundred hours higher. It is not uncommon to find a partner or two in each firm who will work close to 3,000 hours, and we know of a situation in which the partners work in excess of 3,400 hours. For too long, the solution has been placed on the partners' backs, especially in smaller firms, and the sheer weight of this solution is forcing many firms to look at the external marketplace for their salvation.

Valuation of Interests for Internal Buyouts

Book of Business

Under this method of valuing a practice, the owner's book of business is typically valued at a two- or three-year average of annual net revenues. The retirement provision may additionally include a discount factor, reducing this amount to \$0.75 to \$0.95 on the dollar for each dollar of revenue. (The reason for this discount factor applying at all is found in the preceding discussion on why your partners might want to discount your buyout.) In addition, because firms that have a book of business model of valuation usually have little say over client acceptance for the business contained in that book, part of the discount is to offset the marginal business that should be run off or has no value to the remaining owners of the firm.

Unlike the acquisition formulas we previously discussed, with an internal buyout, the remaining partners typically accept the entire book and are responsible for that value. So, a \$0.75 on the dollar price on an internal buyout will likely generate more money to the retiring partner than a \$1 on the dollar acquisition benefit because the acquiring (mergor) firm typically only pays for the clients it decides to keep.

Continuing on, the product of the average annual book size multiplied by this factor, whatever it is, will determine the amount that the firm then owes the retiring partner. This is typically paid over some period of time, with the most common period being 10 years at no interest, while being treated as a fully deductible deferred compensation payment by the firm. According to *The 2008 PCPS Succession Survey*, 42 percent of the firms that use this method (book value) and the owner's equity percentage method (covered subsequently) say they are paying dollar for dollar. However, our experience is that this number is overstated. Our explanation is that many owners think they are going to receive a dollar for dollar benefit when, in fact, we are finding firms waiting to deal with this until right before the partner retires. So, we expect a number of partners will have a rude awakening when their

junior partners balk at this traditional number (something common 10 years ago) and ask for some discount factor to be applied. When the retiring partner threatens to sell his or her book outside, he or she will then realize that some discount is really included in the marketplace, as well. In addition to this deferred compensation (retirement payment), the partner normally gets a return of his or her capital account over a shorter time frame (often 5 years) with interest on the unpaid balance.

Example:

At Cingoranelli and Reeb, Reeb decides to retire. Reeb's average book of business has been calculated at \$1.4 million. The firm retirement SOP states that his buyout will be calculated at \$0.85 on the dollar (85 percent of the calculated average book). Thus, the total retirement obligation of the firm to Reeb is \$1,190,000, payable under the SOP in 10 years without interest.

Reeb's share of the accrual basis capital of the firm is \$400,000 as of the day he retires. The firm will pay him his \$400,000 over 5 years with interest.

Now, the total of these periodic payments may sound like a lot of money and they are, but they're very manageable, too. Assuming Reeb's capital account is paid back at 6 percent interest, the monthly obligation to pay Reeb's retirement benefit and capital would be \$17,649.78, or about \$211,800 per year. At the end of 5 years, the payment due would drop to \$119,000. When you consider that Reeb has been taking out annual compensation of approximately \$600,000 per year, even with the need to promote someone from senior manager to partner, there will be plenty of room left to pay everyone and still have money left to drop to the bottom line. (This all assumes that Reeb has properly transitioned his client relationships; if he hasn't, there should be an adjustment, per our discussion in chapter 8.)

Consider also that the net present value of this purchase, with the same 6 percent we are using to pay interest on capital, would be \$875,851, which is another 26 percent discount. So, in this miniature case study, there was a 15 percent discount off the dollar rate for marginal clients and then another 26 percent discount for being able to pay the retirement benefits over time without interest. If you were buying any other business besides a CPA firm, you would likely have to pay cash up front to make the deal, and even if you didn't, you can bet you would be paying interest (usually higher than prime) on the balance. As for paying back the capital account, this is really his money that the firm is using for capitalization, and in any other sale transaction, he would take all of it when he leaves. So, being able to pay this back over time with interest is just another perk of our profession. In addition, new partners should be building their capital accounts so their influx of money can be used to help balance out or replace the capital payments, as well.

Multiple of Salary

Firms using the multiple of salary method to calculate an owner's retirement benefits usually will take the retiring partner's last 3 years of compensation, the 3 highest years of the last 10 years of compensation, or some variation on this theme to come up with a number

to use to calculate the retirement benefit. Just like the preceding situation, this often is paid out over 10 years with no interest. If the number is small enough, some firms might shorten this period to 5 years. This multiple of salary can run anywhere from approximately one times salary to more than three-and-one-half times salary. *The 2008 PCPS Succession Survey* showed that 38 percent of those who use this method presently use a multiple of three times salary. Once again, we are seeing this drop, especially because average compensation for partners in CPA firms has been on the rise in recent years. So, don't be surprised if you hear your partners wanting to take this number below three times salary; we often hear two-and-one-half-times salary as a proposed solution. In addition, the owner gets a return of his or her capital account over time, with interest, on the unpaid balance.

Example:

Reeb's annual compensation for the last 3 years has been \$600,000. Under the SOP for retirement, the firm is obligated to pay Reeb 3 times that average over 10 years with no interest. The total he would receive under this scenario is \$1,800,000.

Just like the preceding scenario, you also would pay out capital. Once again, when you consider the present value of this at 6 percent of \$1,324,816, the total becomes a much more palatable number.

Ownership Equity Percentage

This method requires the firm to pay benefits based on the partner's share of equity in the firm and the total annual revenues of the entire firm, which likely will be adjusted to somewhere between \$0.75 and \$0.95 on the dollar.

Example:

Cingoranelli & Reeb's average annual net revenue for the firm for the last 3 years has been \$3 million. Reeb owns 49 percent of the equity in the firm. The SOP dealing with retirement benefits calls for the use of an 80 percent factor in making the calculation or paying \$0.80 on the dollar for every dollar of revenue times the retiring partner's equity ownership percentage. Reeb would be entitled to one-tenth of \$1,176,000 every year for 10 years.

Firm average annual net revenues	\$3,000,000
Factor	80%
Equity ownership percentage	49%
Reeb's share	\$1,176,000

Just like the two preceding scenarios, you also would pay out capital, and the present value of this number makes an even better deal.

Which Method Should We Use at Our Firm?

So, which method should you use in your retirement SOP? Each method has its advantages and disadvantages.

The book of business is the common default method for sole owners looking to sell their business to internal or external sources. For all practical purposes, it works the same as

the ownership equity percentage method for a sole proprietor because 100 percent of the business is being sold. In many smaller firms operating under the silo or EWYK business model, the book of business method is the approach used to value the practice of the retiring partner.

As we've previously discussed, what we don't like about this valuation method is that a partner rarely is accountable or has to go through standard client acceptance procedures for his or her clients. This means that a common practice is to never let go of clients, regardless of whether they make money for the firm. Clients are looked at as incremental revenue rather than whether they are profitable because the bigger a partner's client base, the more power he or she tends to wield within the firm.

Finally, the focus is always on individuals building their own book rather than doing what is best for the firm. The book of business method tends to keep firms operating in the EWYK model in both the way they practice and the compensation systems they use. The good news about the book of business model is that it drives firms to quickly grow from the survival mode to the success mode. Once entering the success mode, this method typically has outlived its value and usefulness. (For a more detailed discussion of operational modes and business models, see chapter 7.)

The multiple of salary method is easy to calculate and understand. It is the most common for the larger firms in our profession. It resonates with a lot of people because salary based retirement plans have been used for employees of corporations for years. It also helps keep partners actively engaged until they sell out. However, we have multiple concerns about this method. This method works best for partners who are far enough down the food chain of power and decision making that they have little to no say over their compensation. So, their annual compensation reflects the firm's perspective on their value to the organization. However, in our experience, as partners grow nearer to retirement, these senior partners tend to become more influential in the firm's operational decisions and, therefore, have a great affect on compensation allocation and distribution (partially due to them continually inheriting more equity as the senior partners before them retire). Under this method, it is far too easy for a few partners to manipulate this system and ramp up their retirement benefits at a time when they are most likely to have the influence to pull this off.

A second reason we don't like this method is because no correlation exists between the debt the firm takes on in paying off retiring partners and the overall value of the firm in the marketplace. In other words, it is easy to materially over or undersell the value of the firm using this method.

Third, we don't like this model because it doesn't factor ownership interest into the formula. In other words, you could have 1 partner making \$500,000 with 10 percent ownership of the firm but another making the same amount and only owning 2 percent. They both would receive the same retirement benefit. Just so you can save your breath, the first response people make when we say this is, "This isn't a problem because a reasonable portion of the salary is based on ownership." To that we say, "In our mind, this only creates a bigger problem." We believe that ownership and voting rights, retirement, and annual compensation should be separated because when they are integrated (as they are in many firms), the fact that they are so intertwined tends to minimize the tools a firm can use to hold partners accountable and achieve its strategy and vision (for more information, see *Securing the Future: Succession Planning Basics*).

In our opinion, the ownership equity percentage method is our preferred method of the three. You start by taking a look at the entire value of the firm, and then you discount it based on the ease of keeping clients, the quality of the practice, and the overall profitability. This model is no different than if a group of owners bought their office building together. At the end of the day, each owner will receive his or her equity interest in the building, whatever the market value.

Ownership equity is particularly good for firms using the continuation mode of operation. The good news is that it is hard to overvalue the firm using this method because the discount factor, or premium in previous decades, should be regularly adjusted to reflect something close to market value. Because partners take only their percentage of the overall value, it is harder to materially over or undersell the value of the business. Another big reason we like this approach is because we want to motivate partners to do the right thing for the firm. Under this approach, their actions are not just about maintaining their books of business or pushing their personal salaries as high as possible because, in the end, it is the value of the business that drives their retirement benefit, not the size of the empire they have built in the interim.

The downside to this method, and it is a bad one, is that it can result in a partner coasting into retirement as he or she continues to take decent pay out of the firm while spending less and less time actually working because he or she essentially is guaranteed a great retirement benefit, regardless of whether he or she produces.

As you can see, no one, right or perfect answer exists to the question, “What method should we use to value our partners’ retirement benefits?” We’ve actually recommended a hybrid model to some of our clients; a variation of this can be found in some of the larger firms. Although those larger firms rarely use this model to determine retirement benefits, it often drives part of the salary component. The hybrid can be built a number of different ways. For example, excess profits could be factored into shares to be allocated to partners. Some portion of those excess profits would be split pro rata, with another portion (perhaps 20 percent to 35 percent) allocated based on performance. So, in this case, the ownership equity is slightly adjusted up or down each year for partners having less than average or greater than average years.

Another approach might be to do no annual adjustment of ownership interests, but at the time of retirement, calculate the retirement benefit based on ownership equity then mark that number up or down based on the average annual compensation of the retiring partner to his or her peers. So, in this case, if a partner had average compensation of 10 percent less than his or her peers over the life of being a partner, the retirement benefit might be adjusted downward. This adjustment could come in the form of a straight 10 percent calculation, some portion of 10 percent (perhaps 5 percent), or be a calculated hard number (if the 10 percent represented a \$40,000 per year below average compensation, some multiple of that could be subtracted).

The point isn’t to try to dissect the specific preceding examples but to understand these two conflicting thoughts and how they should be dealt with in your retirement formula:

1. You have an ownership interest in your firm and are doing your share every day, so you are entitled to your ownership interest in the value of that firm.

2. Your personal performance has an effect on the value of the firm. Therefore, you should be rewarded or penalized if your typical performance was consistently more or less than the average performance within your organization.

Many firms have eschewed this model due to its complexity, but we believe it's worth a look in some cases. In the end, the goal is simple: pay partners fairly at retirement for the years of effort, servitude, and sweat they have poured into the firm, balanced against the real market value of the firm.

Some Issues Common to All Three Methods of Valuation

Use of Averages

It's pretty common to see a firm refer to the average of a book of business, firm revenue, or a partner's compensation over some period of time. Often, for book and revenue, the average covers the last 2–3 years. For partner compensation, it is usually the highest couple of years over a 5–10 year period or removal of a couple highs and lows over that same period. Many firms that use salary to calculate this benefit are starting to remove the last 2–3 years from inspection because they want the retiring partners focused on transition and developing their replacements, not on trying to drive up their personal compensation to affect their retirement benefit. By using averages, you quickly take into account any ups and downs that may have occurred from year to year and are basing the formulas on trends rather than exceptions.

Dealing With Outstanding Debt

Outstanding debt has two broad categories. On the one hand, you have the normal debt of the practice, such as accounts payable, accrued expenses, long-term debt for fixed assets, and short-term lines of credit. This debt essentially is netted out in the return of a partner's capital account, which is discussed subsequently. It does not need to be subtracted from any retirement benefit calculation for a retiring partner.

The other category of debt involves outstanding retirement obligations payable to retired partners and any debt incurred in conjunction with mergers and acquisitions. We suggest that the calculated retirement benefit be appropriately reduced by the firm's existing, outstanding retirement obligations to other retired owners, as well as any debt incurred by the firm in any mergers or acquisitions of other practices.

These reductions might at first seem to be counterintuitive but consider the outstanding obligations to retired partners. Because their equity interests were either retired or redistributed, everyone essentially owns a slightly larger piece of the equity pie now. Similarly, if your firm acquires another practice, the overall size of the practice has increased and book sizes of the partners have grown, so any debt taken on to do so needs to be accounted for.

Finally, if you have bought another practice and average partner compensation increases overnight, shouldn't the debt on the recently acquired practice have some effect if compensation is the driver of the benefit calculation?

Example:

In the preceding ownership equity percentage example, Reeb stands to collect \$1,176,000 over 10 years. What if the firm still owed Cingoranelli (who retired somewhat earlier) \$600,000 and had some outstanding merger debt from a recent acquisition of \$300,000? Let's take a look.

Firm average annual net revenues	\$ 3,000,000
Factor	80%
Net revenue after factor	2,400,000
Less retirement obligations	(600,000)
Less merger debt	(300,000)
Total after applicable debt	\$ 1,500,000
Equity ownership percentage	49%
Reeb's share	\$ 735,000

Reeb's retirement has been reduced by \$441,000, which is \$44,100 per year for 10 years. However, if the adjustment had not been made, Reeb would have been paid \$441,000 more than his share of the business's worth. Consider a best case scenario and assume that the outside market would have made Reeb a flat \$0.80 on the dollar offer for his firm with no transition or retainage requirements. You can rest assured that Reeb and his partners would have to assume the payment obligations for the retired partners (the purchaser wouldn't assume these responsibilities without making some price adjustment to recover those amounts). So, we believe outstanding retirement debts and merger or acquisition debt should be reflected in the retirement benefit formulas.

Capital Accounts

Any of the three methods described for calculating a retirement benefit normally also includes paying back the partner's capital account, as well. This repayment normally occurs over a period of time somewhat shorter than the retirement benefit. We see most capital accounts being returned over five years, with interest at the borrowing rate incurred by the firm on outside debt at the time the partner sells his or her ownership interest. Don't fall into the trap of paying for an accrual basis capital account that includes bad receivables or work in process. You should look at a true-up that adjusts the capital after the fact for write-offs and write-downs.

Vesting

We refer to vesting at various times in this material. Historically, mandatory sale of ownership was 55 years of age, with vesting starting around 50 years of age. Today, as we covered in earlier chapters, mandatory sale of ownership is moving to Social Security retirement age, with vesting starting somewhere between 60 and 62 years of age, depending on the firm. Some partners in firms don't like this shift because they don't want to wait that long to retire, so those firms are moving the beginning vesting period to 55 or 57 years of age. Regardless, the vesting period creates a sliding scale. For example, if vesting starts at 62 years of age and continues for 5 years, then it might look something like this:

Age	% Vested
62	50%
63	60%
64	70%
65	80%
66	90%
67	100%

If the vesting period starts at 55 or 57 years of age, we usually see it starting around 10 percent and moving up from there. The one caveat we would suggest, which few firms are addressing, is to require a 2–3 year notice in order to be eligible to invoke those rights or privileges. The point is that you don't want to be surprised and left without time to plan and appropriately respond when someone wants to leave early.

For example, and this has happened many times, consider a situation wherein a partner nearing 67 years of age has been working through the transition process, and everything is proceeding as planned. However, about 2 months after this person's retirement, his or her best friend (who also is a partner and is only 63 years of age) decides working isn't as fun as it used to be since the departure of the best friend. So, the 63-year-old partner gives the firm 6 months' notice and leaves.

Just to make this clear, we have no problem with a partner retiring at 63 years of age and vesting at 60 percent of full retirement benefits. We just have a problem with six months' notice (which does not leave enough time to properly transition clients and develop people to fill the retiring partner's shoes) and having this kind of financial obligation with virtually no time to plan for and get ready to fulfill that obligation. So, in our view, vesting is a right or privilege that you are entitled to only with proper notice.

Other Reductions in Price

Other reasons exist for why a CPA firm owner may realize less in retirement benefit payments than a straight calculation would derive. These reasons include the following:

- Improperly transitioning client relationships
- Publicly disparaging the firm after retirement
- Embarrassing the firm after retirement
- Competing with the firm after retirement

We discussed these matters and ways of dealing with them in chapter 8. The bottom line is that your retirement SOP needs to have language in it that lets partners know that if they retire and do something that damages the firm, you will pursue the issue, and their actions will cost them.

Other Acts Affecting Firm Value or Retirement Value

A variety of acts or actions by owners can and should trigger a change of ownership interests or retirement payouts, including the following:

- Misconduct
- Illegal activities
- Lack of performance
- Death
- Disability

Misconduct or Illegal Activities

Most agreements address the kinds of acts that can result in an owner being forced out of the firm, usually through a clause that covers illegal acts; bankruptcy; moral turpitude; sexual harassment; and other related, undesirable behaviors. Some firms even have a provision that covers acts causing public embarrassment of the firm. We recommend that your agreements include language that allows you to remove partners who commit illegal and other undesirable acts.

What should they get paid? Well, in some cases, the agreements simply provide for a return of capital with no other retirement buyout in these situations. If you think about it, how much value is someone leaving behind if they depart under such circumstances, usually with no opportunity to properly transition client relationships? To the extent that your agreement reduces a retired owner's retirement payout for lost clients, it would effectively take the results of this abrupt departure into account.

Lack of Performance

In some instances, owners may not perform up to agreed-upon standards for the firm. For example, they may not follow firm SOPs for quality, client service, client acceptance, or client retention. They may do such a poor job of managing their professional lives and taking care of business that they're actually running off business or, at best, coasting while someone else carries their load.

The firm needs to be able to deal with these people fairly and equitably for both the firm and the nonperforming owner. The managing partner or CEO will have some latitude to deal with performance within the scope of his or her authority (for example, withholding all or part of the incentive bonus), but normally, the board will determine whether someone gets terminated. You need language in the shareholder agreement that will allow this kind of decision to be made. Too often, the threshold for firing a partner is way too high. We recommend a 66²/₃% vote as high enough to protect partners from a haphazard termination but low enough that one or two allies can't block the move for selfish or self-preservation purposes.

Usually, when a partner is terminated for any reason, the SOP deals with the partner as if he or she were otherwise leaving under any other terms, as far as vesting requirements for retirement pay and enforcement of noncompete provisions are concerned. Generally, we believe that if a partner is terminated and isn't vested, the only financial benefit he or she should be entitled to receive from the firm is his or her capital. Some firms like to pay a minimum termination benefit, which might have an adjusting percentage with each 5 years of service. So, if a partner is terminated after 15 years of service but does not qualify for vesting, perhaps he or she would receive 15 percent (1 percent for each year of service) of his or her retirement benefit as if he or she was fully vested. As we said, we favor zero because we believe the retirement benefit is a function of servitude through vesting.

Death and Disability

Although we talked about these circumstances somewhat in chapter 8, it's worth looking at death and disability here in the context of potential adjustments to retirement payments. Consider the collective trauma that the firm goes through if an owner unexpectedly dies or

becomes totally disabled. We are not attempting to diminish the importance of the personal loss that the family, friends, and partners of the deceased or disabled owner realize. We do want to point out, though, that this horrific turn of events can be disastrous to the firm if casually handled. For clarity, we are going to address them separately.

Death. We recommend that in the case of death, regardless of whether the deceased partner has vested, he or she be considered fully vested for the sake of this policy. However, our generosity ends here. Because we believe you have to protect the firm first, we recommend to our clients to discount the fully vested amount between 25 percent and 50 percent and pay out the benefit over 10 years at no interest (unless covered by life insurance). Some firms will create one discount if the partner was vested at the time of death versus a deeper discount for a partner who never reached the minimum vesting criteria. The reason is simple: the firm's remaining partners will need to jump through a million extra hoops, as well as cope with a great deal of stress to quickly fill the void caused by this trauma. Some likely activities would include a quick transition of clients, personally taking on extra work, potentially promoting someone to fill the vacant partner position, hiring someone from the outside to fill the technical void, and so on. The firm will need extra money to help pay for the significant loss of productivity, lost clients, overtime pay for staff, and other issues that normally occur during crises such as these. For those who feel that our view is terrible, let us remind you that, from our perspective, the partner was not entitled to anything (because he or she either was not vested or did not give proper notice of early retirement). So, although we believe in helping the family of deceased partners for the value they contributed to the firm, we also believe you have to protect the long-term viability of the firm, as well. There is a balance and every firm needs to draw its own lines.

Disability. This one is a little more complicated, partially due to disability insurance often being involved. For simplicity, because we have addressed this numerous ways, we are going to describe the most straightforward approach. Just as with our recommended policy for death, we would suggest considering the totally disabled partner fully vested. From there, for the same reasons we previously discussed, we would discount the value. We recommend that this benefit amount be paid over a ten-year period with no interest, less any payments received through disability insurance.

One other comment: as you can tell, we believe that the firm's policies should require the purchase of insurance to help mitigate the damage to the firm and provide benefit to the partners in the event of these disasters.

Being Fair About the Retirement Policies and Compensation Policies

In many firms, former partners make a part-time contribution to the work of the firm but continue collecting close to full-time compensation, as well as their retirement benefits. This is a travesty and a drain on the firm's resources. It also discourages promising new leaders from wanting to become partners in the first place because of the inequity of the system. Set up a system that pays an owner fairly (market value) for his or her share of the business that was built, and then, at the total discretion of the remaining partners, pay those partners for approved activities and postretirement work.

Conclusion

We hope you have enjoyed the materials presented in this book. We certainly have enjoyed digging deeply into why certain actions and activities occur and how to make sure you are addressing the root causes, rather than the symptoms.

All in all, we believe that succession to the next generation of leaders can be difficult but very manageable. It just requires each owner to start thinking and acting, every day, as if he or she might not be working for the firm tomorrow. How would he or she develop systems, processes, and policies so that his or her unique skills and insights are not required to make the firm operate smoothly? It is about addressing the broken processes that every partner knows are not working. It is about developing a culture in which every partner and employee is thinking about their successor, freeing them up to evolve regarding where they are in the firm and what they do.

This is an exciting time to be in our profession, with more opportunities and rewards than have been experienced by any of our predecessors. We thank you for the time and attention you have given our materials and wish you the best of luck in taking your firm to the next level.





Appendix

PCPS 2008 Succession Survey Results—Sole Proprietor Firms

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This survey summary shows the results for CPA firms with only one owner. It includes responses from the following:

Single owner firms. Single owners of practices that employ professional staff.

Sole (or solo) practitioners. Individual practitioners with no professional employees who may or may not have administrative support staff on board.

The term *sole proprietor*, as used throughout this report, includes both single owner firms and sole practitioners. Survey participants ranged in size from \$44,000 at the low end to \$1,900,000 at the high end of annual revenues, with the average-sized firm having approximately \$500,000 in annual revenues and the median-sized firm having approximately \$360,000 in annual revenues.

Practice Continuation Agreements

Sole proprietors seemingly have not made many changes over the last four years, with respect to instituting practice continuation agreements. In the *2004 PCPS Succession Planning Survey*, 8 percent of sole proprietors indicated that they had an existing practice continuation agreement in place. This year, that number had increased by only one percentage point to 9 percent.

In this year's survey, we asked those who have practice continuation agreements about the content of them. The following table shows the topics covered in existing practice continuation agreements. The last column shows what topics are of most importance to the sole proprietors who have agreements in place.

Topics Covered in Practice Continuation Agreements	Covered in Existing Agreement	Considered "Important" or "Very Important" by Respondents
1. The conditions that trigger the agreement (for example, retirement, death, disability after a specific period of time, and so on).	91%	66%
2. Upon notice of a triggering event (for example, retirement, death, or disability), how fast is the responsible party required to take over the firm?	73%	78%
3. Clear formula for calculation of the sales price of the firm (for example, clients to be included or excluded, method for determining client value, and so on).	64%	75%
4. Payment period and terms.	55%	69%
5. The party responsible to buy your firm is clearly identified (which firm or individual).	55%	64%
6. Definition of disability required to trigger agreement.	45%	55%
7. Outline of payment to firm or person stepping in to keep the firm operating in case of short-term disability (for example, percentage of billings, price per hour, and so on).	45%	55%
8. Provisions for short-term disability.	36%	41%
9. Noncompete clause in place for disabled or retired owner(s).	27%	43%
10. Buyback of practice should disability heal.	18%	39%
11. Plans for existing employees.	9%	57%
12. In case of short-term disability, are there quality controls in place to ensure acceptable standards of work during this period?	9%	52%
13. Client transition plans (in case of retirement).	0%	59%

Perhaps the most meaningful issues from these results for sole proprietors to consider are those listed previously in which the percentages in place are substantially less than the relative importance assigned to them in the last column. In other words, questions 9–13 all have a significant difference in responses between what actually exists in agreements versus what the proprietors feel would be really important to have in their practice continuation agreements.

Noncompete Clause in Place for Retired or Disabled Owner(s)

Although the absence of this provision could be of benefit to the retiring or disabled owner(s), it represents a potential obstacle to the CPA firm taking over the book of business. Considering the staffing, systems, file storage, and maintenance (whether electronic or traditional hard copy) needs that the acquiring firm must address, it would seem that the acquiring firm would want to have some protection in place in the event that the withdrawing sole proprietor chooses to stage a comeback.

Buyback of Practice Should Disability Heal

In this day and age of modern medicine, it's possible that someone out on disability could end up in fair enough health, in spite of doctors' prognoses, to be able to return to work at some level. For the sole proprietor who puts a practice continuation agreement in place, this provision would allow him or her the opportunity to get back in the saddle and work productively at some level. Although 39 percent of the respondents felt this is important, only 18 percent of existing agreements address it.

Plans for Existing Employees

Effectively dealing with employees is a critical consideration in the current and future operating environment for CPA firms. Yet, although 57 percent of the respondents felt this is important, only

9 percent of the continuation agreements have a provision in place dealing with plans for existing employees. The reason it's critical is because a lack of talent is available in the profession. Many small and midsize firm practitioners who might be willing to consider taking over the practice of a retiring or disabled owner(s) may not have the manpower to pull it off unless some or all of the staff come with the practice. Furthermore, having the staff stay with the practice will accomplish two more things for the selling sole proprietor:

1. Creates a win/win for the staff and the practice owner(s) because the staff aren't left looking for a job, and the sole proprietor has helped them. By letting them know of the provisions, he or she has reinforced their worth to the firm, creating a potentially stronger bond.
2. Assures more clients will stay on board with the new firm because they will be seeing some familiar faces with whom they've worked for years.

In case of short-term disability, quality controls in place to ensure acceptable standards of work during this period

Here again, although some 52 percent felt that this is important, only 9 percent of existing agreements cover this provision. The risk to the temporarily disabled sole proprietor is that quality in the new firm, concerning both technical output and service, may not meet his or her previous standards. This can result in a client exodus from which it will be difficult to recover. Talking over these issues is the first step. Memorializing them in the agreement will help ensure that quality is maintained consistently until the sole proprietor is back at work.

Client Transition Plans (in Case of Retirement)

None of the existing practice continuation plans of respondents covered this issue, although 59 percent of the respondents felt it was important or very important. In fact, at multiowner firms where succession management plans are in place, the period of time over which client relationships are transitioned from one owner to the others is often three years. A transition over three years isn't practical for a sole proprietor, but the message here is that you still need to consider what the transition looks like. Oftentimes, we find that the seller makes introductions and makes him or herself available from three to six months to help address client-specific questions with the new firm.

Succession Planning at Sole Proprietor CPA Firms

Ninety-two percent of the sole proprietors said they did not have a succession plan in place, with only 8 percent stating this process was complete. Over half of the sole proprietors indicated that succession planning would be a significant issue for their firm in the near future. Of those that do not have a plan in place, 43 percent will be starting the succession planning process within the next year or two, and 20 percent have either started a plan or have one drafted.

Current Status of Succession Planning	
Will start the process in the next 1–2 years.	43%
Will start the process in about 5 years.	23%
Have started the plan and will soon complete it.	17%
Do not feel the need to have a plan, written or otherwise.	10%
Will start the process in about 10 years.	3%
Have a plan drafted, but it has not been formally approved.	3%

A full 60 percent of sole proprietor CPAs indicated that they will have succession planning challenges over the next 3–10 years, and 32 percent stated that they have current challenges or will have challenges in the next 1–2 years.

Securing the Future: Taking Succession to the Next Level

Timing of Succession Planning Challenges	
We will have succession planning challenges in 3–5 years.	33%
We will have succession planning challenges in 6–10 years.	27%
We will have succession planning challenges in the next 1–2 years.	18%
We have current succession planning challenges.	14%
Our succession planning challenges are over 10 years away.	5%
Succession issues will arise regularly, but we have processes in place to address them.	3%

The previous responses are interesting when viewed in light of the ages of the participants in this survey. Sixty-five percent of the respondents were 55 years of age or older.

Ages of Sole Proprietors Answering Survey	
Under 44 years of age	5%
45–49 years of age	13%
50–54 years of age	18%
55–59 years of age	31%
60–64 years of age	21%
65–69 years of age	11%
Over 70 years of age	2%

As the following table shows, sole proprietors' responses indicated that 40 percent of them plan to sell their practices at retirement to maximize the value of their investment in their firms. A little less than one-third (31 percent) plan to transition their books of business internally, either to existing people or incoming owners. One in 10 will treat their firm as a wasting asset, gradually diminishing the size of the practice, their involvement in it, and their annual income from it. With about one-half of the sole proprietor firms going up for sale or merger, there should be a variety of options for acquiring firms to consider, and this will exert downward pressure on sales prices for retiring sole proprietors.

Likely Transition of the Sole Proprietor Firm	
The firm will most likely be sold so that the senior owner(s) can maximize the value of his or her investment.	40%
The firm and clients of the senior owner(s) will be transitioned to the remaining owner(s) or incoming owner(s), per everyone's expectation.	31%
The firm will most likely be sold due to the lack of confidence of the senior owner(s) in the firm's continuation.	17%
The owner(s) will run the firm long past typical retirement age, maximizing the income of the firm, with diminishing workload and client attrition coinciding throughout this period. If clients are left at the point of full retirement, these will be sold, if possible.	10%
The firm will most likely look for a merger candidate due to the lack of confidence of the senior owner(s) in the firm's continuation, to the surprise or displeasure of the junior owner(s).	6%
The firm will most likely look for a merger candidate in order to fund the retirement of the senior owner(s), which is fully supported by the junior owner(s).	3%
The firm will most likely split up because the remaining group of partners does not have the same vision about the direction of the firm.	0%

Developing Leaders in Sole Proprietor Firms

Over half of the participants indicated that they are not currently developing someone for leadership. However, of those that are, some up-and-coming leaders in sole proprietor firms are being prepared for leadership positions through a variety of activities.

These activities range from identifying specific competencies and training for them to informal coaching, formal training, and mentoring programs. Twenty-nine percent of the sole proprietors indicated that they had no one to develop because they either worked by themselves or they didn't feel the people working for them were leadership material.

What Sole Proprietors Are Doing to Develop Leaders in Their Firms	
Identification of, and training for, specific competencies	53%
Informal coaching by an assigned partner	42%
Formal training or education in delegation and supervision	26%
Experiential assignments chosen to develop competencies	21%
Formal training or education in interpersonal skills	17%
Formal mentoring program	16%
Formal partner-in-training program	6%
AICPA or CPA association formal leadership development programs	4%
Coaching by an outside consultant	4%
Other	29%

Sixty-nine percent of the sole proprietors indicated that they haven't developed formal guidelines for admission of a new owner(s), but they have informal requirements that can change, based on the perspective of the owner(s).

The Firm Environment and People Management in Sole Proprietor Firms

When asked what they are doing to create an environment that will facilitate ownership transition with a minimum of disruption, 39 percent of sole proprietors indicated that they are working at developing their people so more work can be pushed down to them, but they haven't yet begun to spend a lot on staff training. Although 12 percent are spending 5 percent or more of net revenues per year, 70 percent are spending 2 percent or less of net revenues.

Thirty-six percent of sole proprietors stated that they are trying to change the way they operate so that the firm is not built around the expectation that everyone, including the owner(s) or proprietor(s), should put in excessive work hours. One in six are trying to spend more time managing client relationships and less time in the office doing work.

Percent of Net Revenues Spent on Staff Training	
None	2%
0.50%	12%
1.00%	24%
1.50%	11%
2.00%	21%
2.50%	0%
3.00%	14%
3.50%	2%
4.00%	3%
4.50%	0%
5.00%	6%
More than 8.00%	6%

Sole proprietors, on average, have been replacing people who left their firms with an equal number of new hires, for no net gain in staff size. When asked what their expected revenue growth would be for 2008–10, the firm owners indicated an average annual growth rate of approximately 6 percent to 7.5 percent per year, for an expected three year compounded growth rate of approximately 22 percent. The implications should be clear here, inasmuch as that kind of growth will require more net staff additions than their past history shows. When you factor in the inevitable turnover among new hires (not all new hires represent a good fit), it will require an even higher rate of recruitment.

IT expenditures are continually increasing, possibly in part due to the move to convert to paperless work processes and an effort to enhance efficiency through technology. Over 50 percent of sole proprietors are spending 5 percent or more of their operating budget on IT.

Percent of Operating Budget Spent on Information Technology	
None	0%
0.50%	2%
1.00%	3%
1.50%	5%
2.00%	8%
2.50%	5%
3.00%	5%
3.50%	3%
4.00%	15%
4.50%	3%
5.00%	23%
5.50%	8%
6.00%	5%
6.50%	0%
7.00%	3%
7.50%	0%
8.00%	2%
More than 8.00%	12%



Appendix

PCPS 2008 Succession Survey Results—Multiowner Firms

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Survey participants ranged in size from \$100,000 at the low end to \$120 million at the high end of annual revenues, with the average-sized firm having approximately \$5,900,000 in annual revenues and the median-sized firm having approximately \$2,500,000 in annual revenues.

Succession Planning

Written succession plans are now in place for 35 percent of the multiowner firms. Compared with a 25 percent level 4 years ago, this represents a fairly significant movement in the right direction for this group of firms. Similarly, although 19 percent of the multiowner firms felt no need to have a succession plan, written or otherwise, in 2004, only 10 percent of the firms shared this opinion in 2008.

Status of Succession Planning in Multiowner Firms: 2008	
Do not feel the need to have a plan, written or otherwise.	10%
Will start the process in about 10 years.	3%
Will start the process in about 5 years.	10%
Will start the process in the next 1–2 years.	32%
Have started the plan and will soon complete it.	35%
Have a plan drafted, but it has not been formally approved.	9%

Interestingly enough, although only 35 percent of multiowner firms have a formal written and approved succession plan in place, 70 percent expect that succession planning will be a significant issue for them in the near future. This level of expectation is similar to the 68 percent cited in 2004 among these firms. Thus, although many CPAs cognitively understand that a locomotive is headed down the tracks they're on, only about half are doing anything to get off the tracks or operate a metaphorical rail switching mechanism in the form of proactive succession management processes.

In 2004, 11 percent of multi-owner firms were experiencing current succession planning challenges, and 33 percent of them expected succession planning challenges over the next 5 years. By 2008, 20 percent of these CPA firms were experiencing succession planning challenges, and 43 percent still expect succession planning challenges over the next 5 years (63 percent expect succession planning challenges over the next 5 years, and 80 percent will experience succession planning challenges over the next 10 years).

Timing of Succession Planning Needs: 2008	
We have current succession planning challenges.	20%
We will have succession planning challenges in the next 1–2 years.	13%
We will have succession planning challenges in the next 3–5 years.	30%
We will have succession planning challenges in the next 6–10 years.	17%
Our succession planning challenges are over 10 years away.	3%
Succession issues will arise regularly, but we have processes in place to address them.	16%

The previous statistics, compared with prior responses, show that the demographic bubble of baby boomers is, indeed, moving through the profession's pipeline and must be dealt with.

Expected Retirement of Owner(s)

In 2004, 56 percent of the firms said at least one owner would retire in the next 5 years, with 18 percent stating that more than 1 would be retiring. Twenty-nine percent of the firms had partners 63 years of age or older owning 30 percent or more of the firm. Fast forward to 2008, four years later.

The number of firms expecting at least one owner to retire in 5 years currently sits at 63 percent. What's frightening is that 32 percent will have 2 or more owners leaving within the next 5 years.

Partners Retiring in the Next 5 Years	
None	31%
1	31%
2	18%
3	8%
4	3%
5	3%
6	1%
7	0%
8	1%
9	1%
10	1%
11	0%
12	0%
13	0%
14	0%
15	1%
More than 15	1%

In addition to these findings, in 2008, the median ownership interest held by the firms' most senior owner(s) made up 35 percent of the firms' equity, but the median ownership interest held by the second and third most senior partners was 25 percent and 17 percent, respectively.

	Average Age	Average Ownership Percentage	Percent of This Group 60 Years of Age or Older	Average Percentage Owned by 60 Years of Age and Older Group	Percent of This Group 65 Years of Age or Older	Average Percentage Owned by 65 Years of Age and Older Group
Most senior partner	60	35%	52%	29%	20%	25%
Second most senior partner	55	25%	25%	19%	5%	10%
Third most senior partner	51	17%	14%	13%	2%	10%

Note: All figures represent medians (measures of central tendencies); mean values calculate to similar ranges.

Over half the group (52 percent) comprising the "most senior owner" category are 60 years of age or older, with ages ranging into the 70s, a few in their 80s, and one as high as 93 years of age. Twenty-five percent of the second most senior owners are 60 years of age or older, and 14 percent of the third most senior owners are in that age group. Implications for multiowner firms should be obvious: a lot of equity ownership and control will need to be transferred over the next several years as the older owners continue to seek retirement. This can become a boon or a bane to retiring partners and their successors in the firms, due to the sheer magnitude of the numbers involved, as well as the necessary steps that should be taken before these senior owners stage an exit.

Retirement Agreements

A variety of provisions are contained in retirement agreements, including some that are very specific to partner issues dealing with retirement age, allowable activity with clients after retirement, the ability of the retired owner(s) to block mergers, and so on. Generally, responses from this year's survey were similar to those of the 2004 survey. A new issue was introduced into this year's survey that asked about the ability of the existing owner(s) to change the retirement benefit for the retiring partner(s) due to improper client transition. Eighteen percent of the firms indicated that they have a provision covering this issue.

Partner Issues Addressed in Firm's Agreement or Policies	2008	2004
Mandatory retirement age	48%	41%
Allowable activity with clients after retirement to ensure retention	32%	49%
Acceptable arrangements or situations allowing retired owner(s) to continue working for the firm	46%	57%
Personal liability of remaining owner(s) for the full payout to retired owner(s)	27%	28%
Specific recourse or cures should the retired owner(s) not be paid in full	20%	19%
Ability of retired owner(s) to block mergers or total sale of the business unless retirement obligation is paid in full prior to the transaction	11%	9%
Ability of retired owner(s) to block the sale of a line of business unless the retirement obligation is paid in full prior to the transaction	6%	3%
Ability of existing partner(s) to change the retirement benefit of retiring partner(s) due to improper client transition	18%	

(continued)

Securing the Future: Taking Succession to the Next Level

Partner Issues Addressed in Firm's Agreement or Policies	2008	2004
Key person insurance to cover outstanding retirement payment obligations	54%	51%
Acts that can trigger the forced retirement of the owner(s) (illegal activities)	62%	63%
Acts that can trigger the forced retirement of the owner(s) (misconduct, such as sexual harassment, public embarrassment of the firm, and so on)	57%	54%
Acts that can trigger the forced retirement of the owner(s) (lack of performance)	31%	34%
Acts that can trigger the forced retirement of the owner(s) (owner disability)	52%	60%
Other	5%	9%

Concerning funding for the retirement buyouts, it appears that two-thirds of the firms do not plan to fund the retirement buyouts of their owner(s). Of the remaining one-third, 12 percent have not funded the buyouts yet but plan to, and the remaining 21 percent are funding at anywhere from 1 percent to 100 percent, with 4 percent stating that they are funding at 91 percent to 100 percent. This latter statistic tracks with estimates generated from the prior survey in 2004.

Extent of Funding of Equity Buyouts	
0%: We do not plan to fund	67%
0%: We plan to fund	12%
01–05%	1%
05–10%	2%
11–20%	4%
21–30%	2%
31–40%	2%
41–50%	2%
51–60%	2%
61–70%	1%
71–80%	2%
81–90%	0%
91–100%	4%

Owner Compensation— Existing and Retired Owner(s)

In describing compensation systems, the majority of the firms employ some type of salary or base draw, with other elements added in, to compensate the existing partner(s). This year's survey introduced some new elements for compensation systems: profitability of the book of business, profitability of the department, training or development of staff, and leverage of work being done (partner-to-staff ratio). Thirty percent of the firms are using book profitability in their

Elements of Compensation System	2008	2004
Salary or base draw	82%	86%
Ownership percentage	48%	48%
Size of the client book of the owner(s) or the fees managed by the owner(s)	24%	38%
New business developed	34%	28%
Billable or collectible hours	32%	32%
Profitability of book	30%	
Performing certain identified firm functions (managing partner, department head, chairing committees, and so on)	29%	28%
Growing the existing business with a current client	21%	17%
Capital accounts	20%	15%
Training and development of staff	19%	
Cross-selling other services into the client base	14%	11%
Business transferred to other partners or managers	13%	8%
Profitability of department	11%	
Leverage of work being done (ratio of partner to staff work)	10%	
Client satisfaction goals	9%	5%
Other	9%	15%

compensation scheme, but only 10 percent to 11 percent are using measures of leverage or departmental profitability in their systems. Less than 20 percent include a training component in the pay formula.

Firms' compensations plans for their retired partners make use of several elements. This year's questions and options were expanded.

Retired Partner's Compensation Plan	2008	2004
Has been made available to every retired partner	21%	
Has been made available to only a few retired partners	3%	
Will pay the retired owner(s) to bring in new business	14%	20%
Will pay the retired owner(s) a salary to continue working for the firm	24%	26%
Will pay the retired owner(s) a percentage of his or her billings or collections for client work	23%	28%
Will pay the retired owner(s) to remain active in the community, serve on boards of directors, be involved in charity events, and so on	5%	6%
Will pay the retired owner(s) for the book of clients he or she manages	4%	
Is the same for the retired partner(s) as it is for the active partner(s)	2%	
Does not address these issues	41%	34%
Other	15%	11%

Involvement of Owner(s) With Firm After Retirement

Once the owner(s) retires, what types of involvement does he or she have with the firm? We added that question to the survey this time around, and here's what you told us. In over one-third of the firms, retired partners have no involvement with the firm. Nearly a quarter (23 percent) of the firms allow the retired owner(s) to work on some of their old clients (more as a manager) while another partner handles the client relationships. About one in six firms still allow retired partners to manage client relationships.

Involvement of the Retired Owner(s) in the Firm	
The retired owner(s) has no involvement and influence in firm operations.	36%
The retired owner(s) still works on some of his or her old clients but more as a manager because another partner handles the relationship.	23%
The retired owner(s) does what he or she has always done but just works less hours.	17%
The retired owner(s) continues to manage client relationships.	16%
The retired owner(s) is still active in the community and has a formal role of being an ambassador for our firm.	16%
The retired owner(s) is on an annual contract with the firm, with specific allowable activities he or she can perform.	10%
The retired owner(s) is invited to board or management meetings but does not have a vote.	7%
The retired owner(s) still pretty much does what he or she has always done.	4%
The retired owner(s) still works at the firm out of respect, but we always double check his or her work before it goes out.	4%
The retired owner(s) is invited to board or management meetings, and although he or she does not have a vote, he or she is still very influential.	3%
The retired owner(s) is commonly invited to board or management meetings and still votes.	2%
Other	34%

It should be noted that most of the “Other” responses indicated that those firms currently had no retired partners, so this question would apply.

Calculation of Retirement Buyouts

What goes into the calculation used for current owner buyouts at the firms? When it comes to calculating a value for a payout, there seems to be about as many different methods as there are firms. This table and several that follow illustrate this fact.

Methods Used to Calculate Retirement Payouts—Detail	
Retiring partner’s book times an agreed-upon value (for example, \$0.75 cents on the dollar) plus capital plus share of book value	9%
Retiring partner’s book times an agreed-upon value (for example, \$0.75 cents on the dollar) plus capital	9%
Retiring partner’s equity ownership times net revenues (NRs) at an agreed-upon value (for example, \$0.75 cents on the dollar) plus capital plus share of book value	9%
Retiring partner’s equity ownership times NRs at an agreed-upon value (for example, \$0.75 cents on the dollar) plus capital	17%
Retiring partner’s average salary over a number of years times a multiple (for example, salary times 2.5) plus capital plus share of book value	5%
Retiring partner’s average salary over a number of years times a multiple (for example, salary times 2.5) plus capital	12%
Some agreed-to-in-advance number for each partner	11%
Other	28%

“Other” responses contained a potpourri of methods, but most of these responses indicated that the firm had no calculation or hadn’t addressed it yet or that it didn’t apply at this time.

Methods Used to Calculate Retirement Payouts —In General	
Multiple of book	23%
Multiple of ownership percentage	17%
Salary	19%
Other	41%

Multipliers—Revenue or Book Size	
More than \$1 for the \$1	7%
\$1 for the \$1	42%
\$0.95 on the \$1	2%
\$0.90 on the \$1	3%
\$0.85 on the \$1	2%
\$0.80 on the \$1	7%
\$0.75 on the \$1	14%
\$0.70 on the \$1	3%
\$0.65 on the \$1	3%
\$0.60 on the \$1	4%
\$0.55 on the \$1	1%
\$0.50 on the \$1	4%
Less than \$0.50 on the \$1	1%
N/A	6%

For firms using a calculation based on annual volume of the firm or partner book size, 49 percent are using a multiplier of 1.0 or greater. Thirty percent are using a multiplier of 0.75 or less.

Thirty-eight percent of firms utilizing partners' compensation as a primary factor for calculating retirement payouts are using a factor of three times average salary, with 13 percent using a higher factor and nearly half using something less than three times average salary.

Multipliers—Salary	
Less than one year's salary	6%
One year's salary	8%
One year's salary times 1.5	3%
One year's salary times 2.0	17%
One year's salary times 2.5	14%
One year's salary times 3.0	38%
One year's salary times 3.5	3%
More than one year's salary times 3.5	5%
N/A	5%

Exceptions to the Standard Payout Formula

This year, we asked firms if the owner(s) ever receives a payout that is greater or less than the originally prescribed calculation to which he or she had initially agreed. Approximately 10 percent indicated that this has happened at their firms, due to a variety of reasons.

Reasons for Exceptions to Standard Payout Formula	
Senior partner wouldn't retire without additional incentive	12%
Partner's client base was of marginal interest to the firm	15%
Partner wanted to significantly reduce hours of involvement	12%
Partner's recent performance warranted the adjustment	15%
Partner's unethical behavior warranted the adjustment	6%
Partner did not work long enough to meet vesting requirement	6%
Partner was vested but left to compete with the firm	12%
Partner was offered this amount in lieu of termination	9%
Other	50%

Many of the "Other" responses were attributable to partners leaving on short notice or taking clients with them, or both. Nearly half of the adjustments were reductions from the standard retirement payout formula. Over a quarter (26 percent) fell in the 11 percent to 30 percent range.

Adjustments to Standard Retirement Payout Formula	
Below standard retirement payout formula (SRPF)	47%
01%–10% above SRPF	7%
11%–20% above SRPF	13%
21%–30% above SRPF	13%
31%–40% above SRPF	0%
41%–50% above SRPF	7%
51%–75% above SRPF	3%
76%–100% above SRPF	10%
More than double SRPF	0%

Occurrences That Will Force a Change in Duration or Amount of Buyout

In the four years since the first succession planning survey was conducted, more CPA firms have instituted provisions that will result in decreased payouts to retired partners if certain events occur that would otherwise harm the firm. Nearly one-third will now penalize a retired partner for the loss of his or her clients. Of course, as might be expected, early retirement will result in reduced benefits, in addition to competing against the firm after retiring from it.

Events That Will Change Duration or Amount of Payout	2008	2004
Loss of the clients of the retiring owner(s) within 1 year	12%	
Loss of the clients of the retiring owner(s) within 2 years	12%	24%
Loss of the clients of the retiring owner(s) at any time	10%	
Early retirement	36%	31%
Merger	13%	9%
Sale of a line or business	4%	2%
Sale of the business	19%	14%
Uncollectible accounts receivables or work in process	17%	17%
Liabilities incurred after retirement based on the clients of the retiring owner(s)	7%	6%
Violation of noncompete clause	53%	56%
Egregious misconduct in the community	21%	13%
Other	18%	22%

The bulk of the “Other” responses indicated that these provisions didn’t apply or that the firm didn’t have these types of provisions in place.

Owner Noncompete Clause Provisions

The retiring owner(s) at over half (54 percent) of the firms can’t sell accounting-related services and still be entitled to his or her retirement payout. At 43 percent of the firms, the departing owner(s) will pay dollar-for-dollar for each annual dollar of revenue taken, and at 17 percent of the firms, he or she will pay much more than one dollar for each annual dollar of revenue taken.

Owner Noncompete Clause Provisions	
Retired partner(s) cannot sell accounting-related services and still be entitled to his or her retirement payout.	54%
Departing partner(s) taking clients will pay roughly \$1 for each annual dollar of revenue taken.	43%
Departing partner(s) taking clients will pay much more than \$1 for each annual dollar of revenue taken.	17%
Departing partner(s) taking clients will pay a premium for all staff taken.	15%
Retired partner(s) can sell accounting-related services, but those revenues will reduce the retirement payout.	7%
Other	16%

Most of the responses in the “Other” category indicated that they either didn’t have these provisions or an agreement or that this was not applicable to their firm.

Transitioning Soon-to-Be-Retired Owner(s) and His or Her Clients

In 2004, we asked if CPA firms asked the owner(s) to begin transitioning clients to other owners 2-3 years in advance of planned retirement, and 42 percent answered affirmatively. In 2008, we asked if CPA firms require the owner(s) to begin transitioning clients 2-3 years in advance of planned retirement, and 49 percent indicated that they do.

Transitioning Soon-to-Be-Retired Owner(s)	2008	2004
Removed from the firm-wide partner compensation plan, and a special plan is set up to motivate him or her to focus on transition activities	7%	
Asked to start transferring his or her clients to other owners or managers	Not part of 2008 survey	42%
Required to start transferring his or her clients to firm-identified owners or managers	32%	
Required to start transferring his or her clients to owners or managers the retiring owner(s) has selected	17%	
Financially rewarded for specific clients transferred during each year of transition	5%	2%
Financially penalized if a certain number of clients are not transferred each year	4%	1%
No longer compensated for performing hourly billable work on the clients to be transferred during that year	2%	
Not asked to do anything unique until approximately 1 year before from retirement	27%	25%
Do not have any owners planning to retire in the next 5 years, so this is not something we have addressed	23%	31%
Other (N/A, for the most part)	15%	8%

Still, at over one-fourth (27 percent) of the firms, nothing unique is being done until about one year away from retirement. Additionally, only 7 percent of firms change the compensation structure for a retiring partner to allow him or her to focus on transition activities. Given the formulas noted previously in this survey regarding compensation structure, one has to ask why transitioning ever occurs with people being paid to do almost everything but transition.

Challenges Firms Are Trying to Address That Hamper Succession Planning

At 38 percent of the firms, the senior partners don't feel that the younger partners are ready to step up to the leadership positions. Of course, perspectives will vary and perceptions are reality, but one has to ask what the senior partners have been doing in their roles if that many people aren't ready to take on leadership roles, especially because getting the younger partners ready to assume leadership is a function of senior partners' roles and responsibilities.

About one-fourth (26 percent) of the firms don't have written and approved owners' agreements, and at 25 percent of the firms, the owners have

Challenges That Hamper Planning	
Senior partner(s) feels that the younger members of the firm are not ready to step into leadership positions.	38%
The firm does not have a written and approved owner agreement.	26%
Multiple owners with conflicting personal goals.	25%
No penalty can be assessed against the retiring partner(s) for improperly transitioning his or her clients.	22%
The retiring partner(s) is unwilling to transition clients.	18%
The firm does not have a mandatory retirement age, so partners retire in place (working less but drawing large compensation).	14%
The retirement age partner(s) is unwilling to retire.	11%
Retirement payout is based on book size or hours billed, so the retiring partner(s) does a poor job of transition because he or she is motivated to maximize his or her income instead.	7%
The partner(s) has retired but still maintains a significant number of client relationships and, therefore, can consistently make demands of the partner group if we want to keep those clients.	6%
Other	13%

conflicting personal goals. In these firms, these conditions represent potential train wrecks about to happen when someone finally does decide to retire.

Likely Transition of the Firm When the Current Senior Owner(s) Retires

In 2004, 86 percent of CPA firms said that the firm and clients of the senior owner(s) would be transitioned to the remaining owner(s) or incoming owner(s). Now, four years later, this number has dropped somewhat to 79 percent. This year's survey also shows that there could be some surprised junior owners if and when the senior owner(s) decides to merge or sell out, due to the lack of confidence of the senior owner(s) in his or her remaining partner(s). More on leadership follows.

Likely Transition of Firm Upon Retirement of Senior Owner(s)

The firm and the clients of the senior owner(s) will be transitioned to the remaining owner(s) or incoming owner(s), per everyone's expectation.	79%
The firm will most likely look for a merger candidate due to the lack of confidence of the senior owner(s) in the firm's continuation, to the surprise or displeasure of the junior owner(s).	8%
The firm will most likely look for a merger candidate in order to fund the retirement of the senior owner(s), which is fully supported by the junior owner(s).	6%
The firm will most likely be sold so that the senior owner(s) can maximize the value of his or her investment.	11%
The firm will most likely be sold due to the lack of confidence of the senior owner(s) in the firm's continuation without him or her.	4%
The firm will most likely split up because the remaining group of partners does not have the same vision about the direction of the firm.	2%
The senior owner(s) will run the firm long past typical retirement age, maximizing the income of the firm, with diminishing workload and client attrition coinciding throughout this period. If clients are left at the point of full retirement, those will be sold, if possible.	7%
Other (not sure, for the most part)	4%

Leadership Development

Three-fourths (75 percent) of the firms are identifying and training for specific competencies in their up-and-coming leaders. Over half (56 percent) of them provide informal coaching by an assigned partner, but only approximately 1 in 7 use outside consultants for coaching.

Actions Taken Currently to Develop Future Leaders

Identification of, and training for, specific competencies	75%
Informal coaching by an assigned partner	56%
Formal training or education in delegation and supervision	44%
Formal training or education in interpersonal skills	36%
Experiential assignments chosen to develop competencies	25%
Formal mentoring program	24%
AICPA or CPA association formal leadership development programs	17%
Formal partner-in-training program	15%
Coaching by an outside consultant	14%
Other	7%

People Currently in Training or Being Groomed	
None	27%
1	28%
2	19%
3	10%
4	5%
5	3%
6	2%
7	1%
8	1%
9	0%
10	1%
11	0%
12	1%
13	0%
14	0%
15	0%
More than 15	2%

Over one-fourth (27 percent) of the firms have no one in either a formal partner-in-training program or being actively groomed for ownership in the next few years; however, approximately the same number (28 percent), have one person being groomed or formally trained for leadership.

When it comes to identifying and formalizing requirements that people must meet to become new owners, we find a variety of practices in place, but 70 percent of the firms don't have formal written requirements, favoring instead informal requirements that change based on the perspective of the current owner(s). That number is down somewhat from 2004's total of 74 percent of the firms that had no formalized requirements.

Identified and Formalized Requirements for Ownership	
We do not have formal written requirements but, rather, informal ones that change based on the perspectives of the current owner(s).	70%
We have identified crucial competencies that must be met in order to be considered for ownership.	33%
We have identified and documented minimum subjective qualities and characteristics that must be met in order to be considered for ownership.	24%
We have created a nonequity partner track to make sure the new partner(s) fits culturally with the firm before becoming an equity owner.	22%
We have an identified and documented a minimum client book size for the potential owner(s) to meet in order to be considered for ownership.	11%
We have identified a net revenue per partner requirement, so partner slots open up as the firm reaches revenue thresholds.	11%
We have an identified and documented minimum new business development amount for the potential owner(s) to meet in order to be considered for ownership.	6%
We have identified and formalized the requirements to move from nonequity partner to equity partner.	6%
Other	3%

The Firm Environment and People Management in Multiowner Firms

Creating an Environment to Facilitate Succession Transition

Multiowner firms are employing a variety of techniques to create an environment that will help facilitate a smooth transition of power in the succession process. Sixty-nine percent of them indicate that they are making it a priority to develop their people so they can push work down at every level. Forty-three percent are now requiring partners to push the work down to create more leverage. The same number (43 percent) are trying to change the

Percent of Annual Budget Spent on Training and Education	
None	0%
0.50%	5%
1.00%	19%
1.50%	14%
2.00%	21%
2.50%	6%
3.00%	8%
3.50%	2%
4.00%	9%
4.50%	1%
5.00%	6%
5.50%	0%
6.00%	3%
6.50%	0%
7.00%	0%
7.50%	0%
8.00%	1%
More than 8.00%	3%

Creating an Environment to Facilitate Succession Transition	
Making it a priority of the firm to develop people so that work can be pushed down at every level	49%
Requiring the partners to push work down in order to create more leverage	43%
Changing the way you operate so that the firm is not built around the expectation that everyone, including partners, should work excessive work hours	43%
Moving away from the "eat what you kill," or superstar, model of operation	38%
Updated or recently updating your partner or retirement agreements	36%
Requiring the partners to spend more time managing client relationships and less time processing the work in the office	33%
Focusing on training to reverse the staffing pyramid	29%
Holding partners accountable to written operating policies and procedures	27%
Creating clear powers and limitations in the board, executive committee (if you have one), and managing partner roles	25%
Updating your partner compensation system so that the managing partner can hold partners accountable for achieving annual specific goals	20%
Implementing a formal partner-in-training program	17%
Appointing a younger partner as the managing partner rather than promoting by seniority	12%
Other	6%

way they operate so that the firm isn't built around an expectation that everyone, including partners, should put in excessive hours at work. Thirty-eight percent are moving away from an "eat what you kill," or superstar, model of operation.

The foregoing survey results show a variety of approaches for partners to take to prepare the firm for the future. What's interesting is that only 20 percent of the firms have updated partner compensation to hold partners accountable for the other activities they should be doing. Without changing pay systems, it's not likely that behaviors will actually change very much.

Staff Training and Education

Another interesting statistic that comes out of this year's survey is the amount firms are spending for staff training and education. Fifty-nine percent of the firms are spending 2 percent or less of their annual operating budgets on staff development. This stands in stark contrast to the 69 percent of the firms who indicate they are making it a priority to develop people in order to push work down.

Hiring Patterns

Multiowner firms seem to be hiring more aggressively than their sole practitioner counterparts. On average, over the last three years, they indicate that they've hired about 37 percent more people than have left their firms. When asked what their expected revenue growth would be for 2008–10, these firms indicated an expected average annual growth rate of approximately 8 percent to 9 percent per year, for an expected three year compounded growth rate of approximately 29 percent. Although it appears that these firms are addressing the need to hire more people, it remains to be seen whether there will be a large enough supply of graduates to fill their staffing pipelines. In addition, as previously noted, training and development expenditures probably will need to dramatically increase.

IT

IT expenditures are continually increasing, possibly in part due to the move to convert to paperless work processes and an effort to enhance efficiency through technology. Forty-four percent of these practices are spending 5 percent or more of net revenues on IT.

Percent of Annual Budget Spent on IT	
None	0%
0.50%	1%
1.00%	3%
1.50%	5%
2.00%	8%
2.50%	3%
3.00%	13%
3.50%	9%
4.00%	9%
4.50%	2%
5.00%	25%
5.50%	1%
6.00%	5%
6.50%	0%
7.00%	2%
7.50%	2%
8.00%	4%
More than 8.00%	5%





Appendix

2008 PCPS Succession Management Survey Questions

DISCLAIMER: *This publication has not been approved, disapproved, or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the AICPA. It is distributed with the understanding that the contributing authors and editors and the publisher are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.*

1. Which of the following best describes your position in the firm?
 - Sole proprietor managing owner
 - Managing owner
 - Owner
 - Manager
 - Staff
 - Administration
 - Other
2. Do you currently have an existing written practice continuation agreement with some other firm (a practice continuation agreement, generally speaking, outlines the firm that will take over in case of death or disability of the owner(s), compensation of the estate of the owner(s), and so on)

Yes or No
3. Please select all of the topics that are addressed in your practice continuation agreement (select all that apply).
 - The party responsible to buy your firm is clearly identified (which firm or individual).
 - The conditions that trigger the agreement (for example, retirement, death, disability after a specific period of time, and so on).
 - Upon notice of a triggering event (for example, retirement, death, or disability), how fast is the responsible party required to take over the firm?
 - Clear formula for calculation of the sales price of the firm (for example, clients to be included or excluded, method for determining client value, and so on).

- Payment period and terms.
 - Plans for existing employees.
 - Client transition plans (in case of retirement).
 - Definition of disability required to trigger agreement.
 - Provisions for short-term disability.
 - Buyback of practice should disability heal.
 - Outline of payment to firm or person stepping in to keep the firm operating in case of short-term disability (for example, percentage of billings, price per hour, and so on).
 - Noncompete clause in place for disabled or retired owner(s).
 - In case of short-term disability, are there quality controls in place to ensure acceptable standards of work during this period?
 - Other (please specify).
4. Please rate the importance to you of the following topics regarding a practice continuation agreement:
- The party responsible to buy your firm is clearly identified (which firm or individual).
 - The conditions that trigger the agreement (for example, retirement, death, disability after a specific period of time, and so on).
 - Upon notice of a triggering event (for example, retirement, death, or disability), how fast is the responsible party required to take over the firm?
 - Clear formula for calculation of the sales price of the firm (for example, clients to be included or excluded, method for determining client value, and so on).
 - Payment period and terms.
 - Plans for existing employees.
 - Client transition plans (in case of retirement).
 - Definition of disability required to trigger agreement.
 - Provisions for short-term disability.
 - Buyback of practice should disability heal.
 - Outline of payment to firm or person stepping in to keep the firm operating in case of short term disability (for example, percentage of billings, price per hour, and so on).
 - Noncompete clause in place for disabled or retired owner(s).
 - In case of short-term disability, are there quality controls in place to ensure acceptable standards of work during this period?
5. Do you currently have a written and approved succession plan in place? We refer to a succession plan as being a document outlining, at a minimum, the following:
- A buy or sell formula for departing partners agreed to by all partners
 - The identification of which partners are planning to leave and when
 - The steps underway to ensure proper leadership experience and transition
 - An outlined client process with details about the who, what, when, where, and how those clients will be transitioned
 - Successor people identified and being mentored for all key positions in the firm
- Yes or No
6. Please select the one statement that most closely reflects the status of your succession planning.
- We do not feel the need to have a plan, written or otherwise.
 - We will start the process in about 10 years.
 - We will start the process in about 5 years.

- We will start the process in the next 1–2 years
 - We have started the plan and will soon complete it.
 - We have a plan drafted, but it has not been formally approved.
7. Do you expect succession planning to be a significant issue for your firm in the near future?
- Yes or No
8. Please select the one statement that most clearly describes the timing of your succession planning needs.
- We have current succession planning challenges.
 - We will have succession planning challenges in the next 1–2 years.
 - We will have succession planning challenges in 3–5 years.
 - We will have succession planning challenges in 6–10 years.
 - Our succession planning challenges are over 10 years away.
 - Succession issues will arise regularly, but we have processes in place to address them.
9. How many owners will be retiring from your organization in the next 5 years?
10. Which of the following standard operating policies or procedures has your firm formally developed and documented with powers, roles, responsibilities, and limitations (select all that apply)?
- Partner group roles and responsibilities
 - Duties of the partner
 - Executive committee roles and responsibilities
 - Managing partner's roles and responsibilities
 - Retired partner's job descriptions and compensation options
 - Managers and staff roles and responsibilities
 - Admission of partners
 - Partner voting rights
 - Partner compensation plan
 - Partner goals by partner identified each year
 - Manager and staff goals identified each year
 - Capital requirements of a partner
 - New client acceptance
 - Existing client new project acceptance
 - Sale or upstream merger of the entire firm
 - Partner buy-sell valuation
 - Sale of interest (retirement)
 - Business transition
 - Maximum payout of guaranteed payments for retired partners
 - Buy-sell standard operating procedure (SOP) for partner leaving and not taking clients or employees
 - Buy-sell SOP for partner leaving and taking clients or employees
 - Termination of a partner
 - Buy-sell SOP for partner leaving due to death
 - Buy-sell SOP for partner leaving due to total disability
 - Buy-sell SOP for partner leaving due to partial disability
 - General firm policies and procedures (accounts receivable [AR], billing, write-off, and so on)
 - Other (please specify)

11. Which of the following partner issues are addressed in your firm's agreements or policies (select all that apply)?
- Mandatory retirement age
 - Allowable activity with clients after retirement to ensure retention
 - Acceptable arrangements or situations allowing retired owner(s) to continue working for the firm
 - Personal liability of remaining owner(s) for the full payout to retired owner(s)
 - Specific recourse or cures should the retired owner(s) not be paid in full
 - Ability of retired owner(s) to block mergers or total sale of the business unless retirement obligation is paid in full prior to the transaction
 - Ability of retired owner(s) to block the sale of a line of business unless the retirement obligation is paid in full prior to the transaction
 - Ability of existing partner(s) to change the retirement benefit of retiring partner(s) due to improper client transition
 - Key person insurance to cover outstanding retirement payment obligations
 - Acts that can trigger the forced retirement of the owner(s) (for example, illegal activities; misconduct, such as sexual harassment; public embarrassment of the firm; lack of performance; disability of the owner[s], and so on)
 - Other (please specify)
12. Choose the answer that best describes the extent your firm has funded the total equity buyout of your retiring partner(s) [this is not about funding a 401(k) but, rather, about funding for payment for the value of the business, capital, and so on].
- Zero percent—We do not plan to fund
 - Zero percent—We plan to fund
 - One percent to five percent
 - Five percent to ten percent
 - Eleven percent to twenty percent
 - Twenty-one percent to 30 percent
 - Thirty-one percent to forty percent
 - Forty-one percent to fifty percent
 - Fifty-one percent to sixty percent
 - Sixty-one percent to seventy percent
 - Seventy-one percent to eighty percent
 - Eighty-one percent to ninety percent
 - Ninety-one percent to one hundred percent
13. Which of the following describes your compensation system (select all that apply). We pay the owner(s) on
- a salary or base draw.
 - billable or collectable hours.
 - ownership percentage.
 - capital accounts.
 - the size of the client book of the owner(s) or the fees managed by the owner(s).
 - profitability of book.
 - profitability of department.
 - training and development of staff.
 - leverage of work being done (ratio of partner to staff work).
 - new business developed.

- growing the existing business with a current client.
 - business transferred to other partners or managers.
 - performing certain identified firm functions (managing partner, department head, chairing committees, and so on).
 - cross-selling other services into the client base.
 - client satisfaction goals.
 - other (please specify).
14. Which of the following describes your current compensation plan for the retired owner(s) (select all that apply)? Our firm's compensation plan
- has been made available to every retired partner.
 - has been made available to only a few retired partners.
 - will pay the retired owner(s) to bring in new business.
 - will pay the retired owner(s) a salary to continue working for the firm.
 - will pay the retired owner(s) a percentage of his or her billings or collections for client work.
 - will pay the retired owner(s) to remain active in the community, serve on boards of directors, be involved in charity events, and so on.
 - will pay the retired owner(s) for the book of clients he or she manages.
 - is the same for the retired partner(s) as it is for the active partner(s).
 - does not address these issues.
 - Other (please specify)
15. Which of the following best describes the involvement of the retired owner(s) in the firm (select all that apply)?
- The retired owner(s) still does pretty much what he or she has always done.
 - The retired owner(s) does what he or she has always done but just works less hours.
 - The retired owner(s) is commonly invited to board or management meetings and still votes.
 - The retired owner(s) is invited to board or management meetings but does not have a vote.
 - The retired owner(s) is invited to board or management meetings, and although he or she does not have a vote, he or she is still very influential.
 - The retired owner(s) continues to manage client relationships.
 - The retired owner(s) still works on some of his or her old clients but more as a manager because another partner handles the relationship
 - The retired owner(s) has no involvement and influence in firm operations.
 - The retired owner(s) still works at the firm out of respect, but we always double check his or her work before it goes out.
 - The retired owner(s) is on an annual contract with the firm, with specific allowable activities he or she can perform.
 - The retired owner(s) is still active in the community and has a formal role of being an ambassador for our firm.
 - Other (please specify).
16. Which of the following most closely describes the calculation utilized in your current owner retirement payout calculation (select the best option)?
- Retiring partner's book times an agreed-upon value (for example \$0.75 on the dollar) plus capital plus share of book value
 - Retiring partner's book times an agreed-upon value (for example, \$0.75 on the dollar) plus capital

- Retiring partner's equity ownership times net revenues (NRs) at an agreed-upon value (for example, \$0.75 on the dollar) plus capital plus share of book value
 - Retiring partner's equity ownership times NRs at an agreed-upon value (for example, \$0.75 on the dollar) plus capital
 - Retiring partner's average salary over a number of years times a multiple (for example, salary times 2.5) plus capital plus share of book value
 - Retiring partner's average salary over a number of years times a multiple (for example, salary times 2.5) plus capital
 - Some agreed-to-in-advance number for each partner
 - Other (please specify)
17. Which of the following does your firm use to calculate the retirement benefit (select the best answer)?
- Multiple of book
 - Multiple of ownership percentage
 - Salary
 - Other
18. Which of the following best approximates the value of the multiplier you use to calculate the retirement benefit for a retired partner (either book or equity [for example, partner book times \$0.75 on the dollar])?
- More than one dollar for the dollar
 - One dollar for the dollar
 - Ninety-five cents on the dollar
 - Ninety cents on the dollar
 - Eighty-five cents on the dollar
 - Eighty cents on the dollar
 - Seventy-five cents on the dollar
 - Seventy cents on the dollar
 - Sixty-five cents on the dollar
 - Sixty cents on the dollar
 - Fifty-five cents on the dollar
 - Fifty cents on the dollar
 - Less than fifty cents on the dollar
 - N/A
19. Which of the following best approximates the magnitude of the multiplier you use to calculate the retirement benefit for a retired partner (that is, once you have determined the average salary, what is the multiplier used)?
- Less than one year's salary
 - One year's salary
 - One year's salary times 1.5
 - One year's salary times 2.0
 - One year's salary times 2.5
 - One year's salary times 3.0
 - One year's salary times 3.5
 - More than one year's salary time 3.5
 - N/A

20. Has any partner received an owner retirement payout above or below the originally prescribed calculation?

Yes or No

21. Please describe your firm's reasons for offering a retiring partner owner retirement payouts above or below the originally prescribed calculation (select all that apply).
- Senior partner wouldn't retire without additional incentive
 - Partner's client base was of marginal interest to the firm
 - Partner wanted to significantly reduce hours of involvement
 - Partner's recent performance warranted the adjustment
 - Partner's unethical behavior warranted the change
 - Partner did not work long enough to meet vesting requirement
 - Partner was vested but left to compete with the firm
 - Partner was offered this amount in lieu of termination
 - Other (please specify)
22. Choose the option that best describes the change in the retiring partner's payout and overall package from what was originally prescribed.
- Below standard retirement payout formula (SRPF)
 - One percent to ten percent above SRPF
 - Eleven percent to twenty percent above SRPF
 - Twenty-one percent to thirty percent above SRPF
 - Thirty-one percent to forty percent above SRPF
 - Forty-one percent to fifty percent above SRPF
 - Fifty-one percent to seventy-five percent above SRPF
 - Seventy-six percent to one hundred percent above SRPF
 - More than double SRPF
23. Which of the following occurrences will force a change in the payment duration, monthly payment amount, or total payout amount of standard calculated retirement pay (select all that apply)?
- Loss of the clients of the retiring owner(s) within one year
 - Loss of the clients of the retiring owner(s) within two years
 - Loss of the clients of the retiring owner(s) at any time
 - Early retirement
 - Merger
 - Sale of a line or business
 - Sale of the business
 - Uncollectible AR or work in process
 - Liabilities incurred after retirement based on the clients of retiring owner(s)
 - Violation of noncompete clause
 - Egregious misconduct in the community
 - Other (please specify)
24. Which of the following is true of your partner noncompete clause or employment agreement (select all that apply)?
- Retired partner(s) cannot sell accounting-related services and still be entitled to his or her retirement payout.
 - Retired partner(s) can sell accounting-related services, but those revenues will reduce the retirement payout.

- Departing partner(s) taking clients will pay roughly \$1 for each annual dollar of revenue taken.
 - Departing partner(s) taking clients will pay much more than \$1 for each annual dollar of revenue taken.
 - Departing partner(s) taking clients will pay a premium for all staff taken.
 - Other (please specify).
25. When owner(s) is from two to three years away from retirement, which of the following describes your firm (select all that apply)? The soon-to be-retiring owner(s)
- is removed from the firm-wide partner compensation plan, and a special plan is set up to motivate him or her to focus on transition activities.
 - is required to start transferring his or her clients to firm-identified owners or managers.
 - is required to start transferring his or her clients to owners or managers the retiring owner(s) has selected.
 - is financially rewarded for specific clients transferred during each year of transition.
 - is financially penalized if a certain number of clients are not transferred each year.
 - is no longer compensated for performing hourly billable work on the clients to be transferred during that year.
 - is not asked to do anything unique until approximately one year before retirement.
 - We do not have any owners planning to retire in the next five years, so this is not something we have addressed.
 - Other (please specify).
26. Which of the following describes the likely transition of your firm when the current senior owner(s) retire (select all that apply)?
- The firm and the clients of the senior owner(s) will be transitioned to the remaining owner(s) or incoming owner(s), per everyone's expectation.
 - The firm will most likely look for a merger candidate due to the lack of confidence of the senior owner(s) in the firm's continuation, to the surprise or displeasure of the junior owner(s).
 - The firm will most likely look for a merger candidate in order to fund the retirement of the senior owner(s), which is fully supported by the junior owner(s).
 - The firm will most likely be sold so that the senior owner(s) can maximize the value of his or her investment.
 - The firm will most likely be sold due to the lack of confidence of the senior owner(s) in the firm's continuation without him or her.
 - The firm will most likely split up because the remaining group of partners does not have the same vision about the direction of the firm.
 - The senior owner(s) will run the firm long past typical retirement age, maximizing the income of the firm, with diminishing workload and client attrition coinciding throughout this period. If clients are left at the point of full retirement, those will be sold, if possible.
 - Other (please specify).
27. Which of the following are you doing right now to develop the future leaders of your firm (select all that apply)?
- Identification of, and training for, specific competencies
 - Formal training or education in delegation and supervision
 - Formal training or education in interpersonal skills
 - AICPA or CPA association formal leadership development programs
 - Experiential assignments chosen to develop competencies

- Formal mentoring program
 - Formal partner-in-training program
 - Informal coaching by an assigned partner
 - Coaching by an outside consultant
 - Other (please specify)
28. How many individuals are either (1) currently in a formal partner-in-training program or (2) being actively groomed for ownership in the next few years?
29. What are the identified and formalized requirements for the new owner(s) (select all that apply)?
- We do not have formal written requirements but, rather, informal ones that change based on the perspectives of the current owner(s).
 - We have an identified and documented a minimum client book size for the potential owner(s) to meet in order to be considered for ownership.
 - We have an identified and documented minimum new business development amount for the potential owner(s) to meet in order to be considered for ownership.
 - We have identified and documented minimum subjective qualities and characteristics that must be met in order to be considered for ownership.
 - We have identified crucial competencies that must be met in order to be considered for ownership.
 - We have identified an NR per partner requirement, so partner slots open up as the firm reaches revenue thresholds.
 - We have created a nonequity partner track to make sure the new partner(s) fits culturally with the firm before becoming an equity owner.
 - We have identified and formalized the requirements to move from nonequity partner to equity partner.
 - Other (please specify).
30. Please select examples of what you are doing right now to create an operating environment that will facilitate the transition of power with minimal disruption of profitability, culture, services, and so on between the retiring owner(s) and the remaining owner(s) (select all that apply).
- Moving away from the "eat what you kill," or superstar, model of operation
 - Creating clear powers and limitations in the board, executive committee (if you have one), and managing partner roles
 - Appointing a younger partner as the managing partner rather than promoting by seniority
 - Implementing a formal partner in-training program
 - Holding partners accountable to written operating policies and procedures
 - Updating or recently updated your partner or retirement agreements
 - Focusing on training to reverse the staffing pyramid
 - Making it a priority of the firm to develop people so that work can be pushed down at every level
 - Requiring the partners to push work down in order to create more leverage
 - Requiring the partners to spend more time managing client relationships and less time processing the work in the office
 - Updating your partner compensation system so that the managing partner can hold partners accountable to achieving annual specific goals
 - Changing the way you operate so that the firm is not built around the expectation that everyone, including partners, should work excessive work hours
 - Other (please specify)

31. Identify challenges you are trying to address that are hampering the success of your firm's succession strategy (select all that apply).
- The retirement age partner(s) is unwilling to retire.
 - The retiring partner(s) is unwilling to transition clients.
 - Senior partner(s) feels that the younger members of the firm are not ready to step into leadership positions.
 - Retirement payout is based on book size or hours billed, so the retiring partner(s) does a poor job of transition because he or she is motivated to maximize his or her income instead.
 - No penalty can be assessed against the retiring partner(s) for improperly transitioning his or her clients.
 - The partner(s) has retired but still maintains a significant number of client relationships and, therefore, can consistently make demands of the partner group if we want to keep those clients.
 - The firm does not have a mandatory retirement age, so partners retire in place (working less but drawing large compensation).
 - The firm does not have a written and approved owner agreement.
 - Multiple owners with conflicting personal goals.
 - Other (please specify).
32. Which answer best categorizes the average annual owner compensation in your most recent complete year (select one)?
- The list included options from "less than \$75,000" to "above \$500,000."
33. Age and ownership percentage of your firm's most senior partner.
34. Age and ownership percentage of your firm's second-most senior partner.
35. Age and ownership percentage of your firm's third-most senior partner.
36. What resources have you utilized that have been valuable in assisting your firm with succession process and planning (select all that apply)?
- The PCPS book *Securing the Future: Succession Planning Basics*
 - Hiring consultants to help with the planning process
 - AICPA conference education
 - Education provided by your firm association
 - Education provided by your state society
 - Other (please specify)
37. The final seven questions require some general firm financial and statistical information. This information is very valuable in helping us understand and develop our succession Web site, as well as build future materials and tools. Choose "Yes" if you are willing to answer the financial questions or "No" if you do not want to answer them and skip to the end of the survey.
- Yes or No
38. In the last three years, what is the average number of new hires per year at your firm?
- The list contained options from 1 to "more than 30."
39. In the last three years, how many people, on average, have left the firm each year (for reasons such as fired, moved, went to work for another firm, and so on)?
- The list contained options from 1 to "more than 30."

40. Please answer the following demographic questions regarding the number of personnel within the firm. The total of your first three responses should equal the fourth blank (the total number of full-time equivalents [FTEs] in the entire firm).
- Owners:
 - Professional employees, excluding owners:
 - Paraprofessional and administrative employees:
 - Total FTEs:
41. Please answer the following demographic questions regarding your firm's NRs (gross revenues less write-offs or billed fees, rounded to the nearest \$100k). The total of your responses to the seven questions should equal the NR for the firm and its majority owned entities.
- NR for tax services:
 - NR for audit and assurance services:
 - NR for bookkeeping, controllership, and payroll type services:
 - NR for financial planning and wealth management services:
 - NR for business advisory or consulting services:
 - NR for valuation and litigation support services:
 - NR for all other services:
 - Total NR (total of preceding items):
42. Please indicate the expected percentage change in NR for the periods identified subsequently. Please represent all numbers as integers followed by the percent sign (for example, 10 percent growth as 10% or a 5 percent decline as -5%).
- Growth % for 2008
 - Growth % for 2009
 - Growth % for 2010
43. On average, what percent of your annual operating budget is spent on IT (please include equipment, software, and IT support personnel)?
- The list contained answers from "none" to "more than 8%."
44. On average, what percentage of your annual operating budget is spent on staff training and continuing education?
- The list contained answers from "none" to "more than 8%."



